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Changing U.S. Tax Jurisdiction: Expatriates, Immigrants, and the Need for a Coherent Tax Policy

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I. INTRODUCTION

One of the most contentious tax legislative battles of the 104th Congress erupted over the Clinton administration's proposal to amend the U.S. tax rules applicable to expatriates.[1] The administration proposed taxing the abandonment of either U.S. citizenship or long-term U.S. tax residency.[2] The administration's proposal responded to a number of articles in the popular press that described the U.S. tax benefits of expatriation and divulged the names of well-heeled expatriates.[3] Proponents claimed that Congress needed to revise the taxation of expatriates to prevent "billionaire Benedict Arnolds" from avoiding "their fair share" of U.S. income taxes.[4] Opponents argued that the Clinton proposal would affect foreign investment in the United States

1. For purposes of this Article, "expatriate" refers to a U.S. citizen who renounces her citizenship or a U.S. resident alien who abandons her U.S. residency and thereafter becomes, for a period of time, a nonresident alien for U.S. income and transfer tax purposes.

2. Any property held by the expatriate at the time of expatriation would be deemed to be sold for its fair market value, and any net gain in excess of $600,000 from the deemed sales would be subject to U.S. income tax. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1996*, as released on Feb. 6, 1995, *available in* LEXIS, Fedtax Library, TNT File, 95 TNT 25-28; *see also*, *Treasury Department General Explanation of Revenue Proposals in Clinton Administration's FY 1996 Budget Request*, Feb. 6, 1995, *available in* LEXIS, Fedtax Library, DTR File, DTR 25 d85.

3. Nancy Loube, *Expatriate Taxation: Politics Obscures Technical Issues*, 10 TAX NOTES INT'L 1377 (Apr. 17, 1995). The article was probably Robert Lenzner's and Philippe Mao's, *The New Refugees*, FORBES, Nov. 21, 1994, at 131. For some reason, the expatriate issue especially captivated the editors of Forbes as this was the second article on expatriation to appear in Forbes in 1994. The first was Brigid McMenamin, *Flight Capital*, FORBES, Feb. 28, 1994, at 55.

4. Remarks of Rep. Neil Abercrombie on House Floor (Mar. 30, 1995), *available in* LEXIS, Fedtax Library, TNT File, 95 TNT 70-27 ("What we have here are not expatriates, what we have here are Benedict Arnolds, Benedict Arnolds who would sell out their citizenship, sell out their country in order to maintain their wealth.").

and compared it to the loathed exit tax imposed by the former Soviet Union on emigrants.[5]

After the introduction of the administration's expatriate provisions,[6] a legislative debate ensued.[7] The Senate favored the administration's approach, under which an expatriate's property would be deemed to be sold for its fair market value—marked to market—on the date of expatriation. The House, however, generally favored retaining the existing expatriate regime, under which a tax-motivated expatriate is taxed like a citizen on income from the United States for ten years following expatriation.[8] The House version passed Congress as part of the Health Insurance Portability and Accountability Act of 1996 and was signed into law on August 21, 1996.[9]

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5. Testimony of William K. Norman at Committee on Ways and Means Oversight Subcommittee Hearing on Expatriate Tax, Mar. 27, 1995, *available in* LEXIS, Fedtax Library, TNT File, 95 TNT 60-23 ("Exit tax on certain U.S. citizens who renounce their citizenship is bad tax policy with likely detrimental economic consequences."); Testimony of Rabbi Jack Moline at Ways and Means Oversight Subcommittee Hearing on Expatriate Tax, Mar. 27, 1995, *available in* LEXIS, Fedtax Library, TNT File, 95 TNT 60-27; Testimony of Professor Robert F. Turner, Naval War College, at Ways and Means Oversight Subcommittee Hearing on Expatriate Tax, Mar. 27, 1995, *available in* LEXIS, Fedtax Library, TNT File, 95 TNT 60-22 (expatriate provision violated U.S. international human rights obligations).

6. The expatriate provisions were contained in identical House and Senate bills which were both introduced on February 16, 1995. H.R. 981, 104th Cong., § 201 (1995); S. 453, 104th Cong., § 201 (1995).

7. Karen De Witt, *Some of Rich Find a Passport Lost is a Fortune Gained*, N.Y. TIMES, Apr. 12, 1995, at A1 (describing legislative battle over expatriate provisions); Jerry Gray, *Wrangling in Senate Again Bars Vote on Midyear Tax Budget Cuts*, N.Y. TIMES, Apr. 1, 1995, at A26 (detailing how battle over expatriate provisions delayed vote on tax legislation).

8. I.R.C. § 877 (West 1989 & Supp. 1996) (income tax); I.R.C. § 2107 (West 1989) (estate tax); § 2501(a)(3) (West 1989 & Supp. 1996) (gift tax). Unless otherwise indicated, all statutory references in this article are to the Internal Revenue Code ("Code") of 1986, as amended, and the Treasury Regulations issued thereunder. The reasons put forth by the House supporters were (1) the existing expatriate provisions could be improved with technical amendments; and (2) such amendments would raise more money than the administration proposals. *See* Barbara Kirchheimer, *Ways and Means Committee Approves Archer Expatriate Bill Amid Fight Over Revenue Estimates*, June 14, 1995, *available in* LEXIS, Fedtax Library, TNT File, 95 TNT 115-1 (stating that Rep. Archer's preference for H.R. 1812 [House version] was apparently due to the fact that it was estimated to raise four times more revenue than the administration's proposal). The revenue projected to be raised by the expatriate proposals provoked a considerable debate between the revenue estimating staffs of the Joint Committee on Taxation and the Treasury Department.

9. P.L. 104-191, §§ 511-513, 110 Stat. 2093, H.R. 3103, 104th Cong. (1996) (enacted). A slightly different House version passed Congress as part of the Revenue Reconciliation Act of 1995, but was vetoed by President Clinton. H.R. 2491, 104th Cong. (1996).

The expatriate debate engendered a voluminous legislative history. Hearings were held both in the Senate and House, and the Joint Committee on Taxation produced three

It would be easy to interpret the expatriate tax debate as merely a convenient opportunity for political one-upmanship. For the last sixty years, however, Congress and the Treasury have grappled with the vexing issue of how properly to tax expatriates.

The need for special expatriate tax provisions arises because of the different U.S. tax regimes that apply to citizens and residents on the one hand, and to nonresident aliens on the other.[10] U.S. citizens and residents are generally subject to U.S. income tax at graduated rates on their worldwide income, and to U.S. estate, gift, and generation-skipping taxes on their worldwide estates, gifts, and generation-skipping transfers.[11] In tax patois, this is referred to as residence basis taxation. Nonresident aliens, in contrast, are subject to U.S. income tax at a flat thirty percent rate on U.S. source investment income and net basis taxation on U.S. trade or business income. Generally, nonresidents are subject to U.S. transfer taxes only on transfers of U.S. situs property.[12] This is referred to as source basis and trade or business basis taxation.

Because of the different scope of each regime, the tax liability computed under one regime may vary significantly from that computed under another. For example, a citizen with appreciated IBM stock could greatly reduce or eliminate any future U.S. income and transfer tax liability by renouncing his citizenship and becoming a nonresident alien. To check tax-motivated expatriation, tax-motivated expatriate citizens have been subject to a special income, gift, and estate tax regime since

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detailed reports. *See Background and Issues Relating to Taxation of U.S. Citizens Who Relinquish Their Citizenship* (JCX-14-95), Mar. 20, 1995, *available in* LEXIS, Fedtax Library, TNT File, 95 TNT 56-13. For the House hearings, see *Background and Issues Relating to Taxation of U.S. Citizens Who Relinquish Their Citizenship and Long-term Resident Aliens Who Relinquish Their U.S. Residency* (JCX-16-95), Mar. 20, 1995, *available in* LEXIS, Fedtax Library, TNT File, 95 TNT 59-36. As part of the law extending the health insurance deductions for self-employed persons, the Joint Committee was directed to conduct a study on the issues raised by expatriation and report back to the House Ways and Means and Senate Finance Committees by June 1, 1995. *See* H.R. 831, 104th Cong. § 6 (1995). The report produced was the Joint Committee on Taxation Staff Report, *Issues Presented by Proposals to Modify the Tax Treatment of Expatriation* (JCS-17-95), June 2, 1995 [hereinafter referred to as JCT Report 3].

10. *See infra* text accompanying notes 15-90.

11. *See* I.R.C. § 1 (West 1989); I.R.C. § 2001 (West 1989); I.R.C. § 2501 (West 1989 & Supp. 1996); I.R.C § 2601 (West 1989) (covering income, estate, gift, and generation-skipping taxes, respectively).

12. *See infra* text accompanying notes 137-194.

1966.[13] The policy underlying these provisions is to dissuade tax-motivated expatriation by taxing tax-motivated expatriates on the same basis as U.S. citizens but only with respect to *U.S. source income and transfers of U.S. situs property* for ten years following expatriation.

Despite these provisions, a substantial incentive to expatriate still exists if a taxpayer owns foreign situs property or property that produces foreign source income. The only way to tax an expatriate the same as a citizen would be to tax her worldwide income and transfers of property. Such exertion of tax jurisdiction would contravene accepted norms of international taxation and may raise constitutional issues. More practically, taxation of the worldwide income of expatriates would be virtually impossible to administer, especially when the person and property were located outside of the United States.

Related issues also arise when persons and property become subject to U.S. tax. For example, if a person becomes a resident alien or citizen and owns property that has either increased or decreased in value since the date of purchase, these accrued gains or losses may affect U.S. tax liability. If the person is well advised, however, he will realize the gains prior to becoming a resident and defer realizing the losses until after becoming a resident. Thus, the current regime often imposes U.S. tax only on the unwary.

Over the last eighty years, Congress has failed to develop a coherent approach to persons and property changing U.S. tax jurisdiction. Congress has enacted a comprehensive regime to address the transfer of property outside the U.S. when the beneficial owner of the property continues to be subject to U.S. residence basis taxation. This regime, however, is inconsistent with that applicable to property leaving and entering U.S. tax jurisdiction because the owner of the property leaves (expatriates) or enters U.S. tax jurisdiction, even though identical tax policy issues arise.

In this Article, I argue that Congress should adopt a mark-to-market tax regime for persons and property that enter or leave U.S. residence or trade or business taxation. Mark-to-market taxation embodies sound tax policy.[14] It better reflects the ability-to-pay norm, because it includes

13. In 1984, the income tax prong of this regime was extended to cover U.S. resident aliens who ceased to be U.S. residents and within a three-year period regained their U.S. residency, regardless of the motive for abandoning U.S. residency. I.R.C. § 7701(b)(10) (West 1989 & Supp. 1996).

14. The Clinton administration proposal was presaged in a report by the Association of the Bar of the City of N.Y. Committee on Taxation of International Transactions, *The Effect of Changes in the Type of United States Tax Jurisdiction Over Individuals and Corporations: Residence, Source, and Doing Business*, 46 THE REC. OF THE ASS'N OF THE BAR OF THE CITY OF N.Y. 914 (1991) [hereinafter City Bar Report].

in the tax base all changes in a citizen's net wealth. It also better reflects the norm of economic rationality, because all gains—U.S. and foreign—are taxed. Any attempt to equalize the U.S. tax liabilities of an expatriate with her tax liabilities had she remained a citizen or resident is a sisyphean task and should be abandoned. No matter which system is in place, a nonresident will almost always pay less U.S. tax than a citizen, and consequently there will always exist a tax incentive to expatriate. In order to protect the integrity of the U.S. tax system, however, the realization principle should be relaxed when persons or property enter or leave U.S. tax jurisdiction to ensure that accrued gains, losses, and income are properly taxed.

A mark-to-market regime for expatriates is also conceptually consistent with Code provisions aimed at protecting residence basis taxation, and is similar to the approach adopted by Canada and Australia. A mark-to-market regime applicable to all persons and property entering or leaving U.S. tax jurisdiction would also eliminate the current hodgepodge of (oftentimes contradictory) rules applicable to persons and property entering or leaving U.S. tax jurisdiction. Finally, it may ease administrative burdens and bolster the public's perception that the tax system is "fair" and cannot be gamed easily by wealthy expatriates, an important consideration for a tax system based on self-reporting.

Part II of this Article briefly summarizes the current U.S. income and transfer taxation of citizens, residents, and nonresidents, and discusses the Code provisions that are intended to protect residence basis tax jurisdiction. Part III focuses on the challenges to the U.S. tax system that expatriation poses and argues that mark-to-market taxation is the appropriate response. Part IV addresses policy issues that would arise under an accrual tax system for expatriates and immigrants. Part V discusses the current U.S. expatriate tax regime. Part VI addresses the analogous tax issues raised by foreigners becoming resident aliens or

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One of the members of the committee that drafted the report was Leslie Samuels, who was Assistant Secretary (Tax Policy), Treasury Department during the 104th Congress, and thus responsible for developing and lobbying for the administration proposal. A mark-to-market regime for property brought into U.S. tax jurisdiction was recommended over forty years ago in Harry F. Weyher & Augustus W. Kelley, *The Income Taxation of Aliens—Some Riddles and Paradoxes*, 9 TAX. L. REV. 371, 395-99 (1954). For an excellent different view on expatriation, *see* Alice G. Abreu, *Taxing Exits*, 29 U.C. DAVIS L. REV. 1087 (arguing that expatriates should not be subject to mark-to-market taxation because loss of citizenship is already a high enough price).

citizens or bringing property into a U.S. trade or business. In addition, Part VII considers some ancillary issues raised by a mark-to-market regime.

II. U.S. INCOME AND WEALTH TRANSFER TAXATION

A. Income Tax

1. Citizens and Residents—Residence Basis Taxation

Since the enactment in 1913 of the first modern federal income tax on individuals, the United States has taxed both its citizens and resident aliens[15] on their worldwide income at graduated rates.[16] The U.S.

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15. For U.S. tax purposes, "citizen" refers to an individual who is either born or naturalized in the U.S. Acquisition of U.S. citizenship is determined under the Immigration and Nationality Act, 8 U.S.C. §§ 1401-1459 (1994). *See* Treas. Reg. § 1.1-1(b) (1996). A U.S. citizen who also possesses dual or multiple citizenship is treated as a U.S. citizen. *See* Matheson v. United States, 532 F.2d 809, 816 (2d Cir. 1976), *cert. denied*, 429 U.S. 823 (1976) (absent a specific intent to relinquish citizenship, a citizen with dual citizenship is still treated as a U.S. citizen for purposes of income and gift taxes); Rev. Rul. 75-82, 1975-1 C.B. 5.

A "resident alien" is an alien who (1) is lawfully admitted for permanent residence at any time during the calendar year; (2) satisfies the substantial presence test; or (3) elects to be treated as a resident alien. I.R.C. § 7701(b)(1)(A)(i), (ii), (iii) (West 1989 & Supp. 1996). An alien is a lawful permanent resident if at any time during the calendar year the alien holds a green card. I.R.C. § 7701(b)(6)(A). Once a green card holder, an alien continues to be a United States resident unless resident status has been rescinded or judicially or administratively determined to be abandoned, regardless of whether the alien continues to reside in the United States. I.R.C. § 7701(b)(6)(B). An alien satisfies the substantial presence test if present in the United States for at least 31 days during the calendar year and 183 days or more over the three-year period that includes the current year and previous two years. I.R.C. § 7701(b)(3)(A). In calculating whether an alien is present in the United States for more than 183 days, each day of presence in the current year counts as one day; each day of presence in the immediately preceding year counts as one-third of a day; and each day of presence in the second preceding year counts as one-sixth of a day.

16. The Code does not explicitly provide for the taxation of the worldwide income of U.S. citizens and residents. The regulations under section 1 state that U.S. citizens and residents, wherever actually residing, are subject to taxation on worldwide income. *See* Treas. Reg. § 1.1-1(a) ("Section 1 of the Code imposes an income tax on the income of every individual who is a citizen or resident of the United States"); Treas. Reg. § 1.1-1(b) ("In general, all citizens of the United States, wherever resident, and all resident alien individuals are liable to the income taxes imposed by the Code whether the income is received from sources within or without the United States."). There is one important exception to the general rule that U.S. citizens and residents are taxed on their worldwide income. *See, e.g.*, I.R.C. § 911 (West 1989) (exclusion for foreign source earned income). The rules for determining the source of income—U.S. or foreign—are generally found in sections 861-65. Since U.S. citizens and residents are taxed on worldwide income, the source rules are largely relevant to them only to determine the foreign tax credit limitation under section 904.

taxation of the worldwide income of its citizens, residents, and domestic corporations has been described as one of the "cornerstones" of U.S. international tax policy.[17] The Supreme Court, in *Cook v. Tait*,[18] upheld the U.S. taxation of the worldwide income of its citizens, regardless of a citizen's domicile or the location of his property.[19]

Although the Court in *Cook* stressed the worldwide benefits received by citizens, its opinion should not be construed as positing a benefits theory of taxation, but rather as merely upholding Congress's power to tax the worldwide income of its citizens and residents.[20] Congress clearly has the power to tax the worldwide income of its citizens, regardless of whether it actually confers any benefits.[21]

Worldwide taxation is most easily justified by the ability-to-pay and economic neutrality principles, which undergird our income tax system. According to the ability-to-pay principle, an individual's tax contribution should be measured by the economic resources—including both current

17. Kenneth W. Gideon, *Dinner Speech*, 9 AM. J. TAX POL'Y 71, 72 (1991) ("Principle number one: people should pay equal taxes on their income regardless of the country that is the source of that income. United States taxpayers should be treated equally regardless of the income source.").

18. 265 U.S. 47 (1924).

19. *Id.*; *see also* National Paper & Type Co. v. Bowers, 266 U.S. 373 (1924), in which the court rejected a due process claim of domestic corporation subject to U.S. tax on income from foreign sales where foreign corporations were not subject to the same tax on similar transactions

20. The Court in *Cook* did not explicitly delineate the constitutional grounds for its decision. The scope of congressional taxing power is unclear. For instance, could Congress constitutionally tax the income of a French vintner with no nexus to the U.S.? A discussion of the constitutional limits of Congress's power to tax is beyond the scope of this Article. One can question the fairness of taxing the worldwide income of nonresident citizens. Currently, the only other two countries that tax the worldwide income of their nonresident citizens are Eritrea and the Philippines. JCT Report 3, *supra* note 9, at A-4. For a discussion of the historical development and consequences of the different tax systems and different assertions of jurisdiction to tax, see Martin Norr, *Jurisdiction to Tax and International Income*, 17 TAX L. REV. 431 (1962).

21. Taxpayers who have argued that *Cook* requires some modicum of benefits have not been successful. *See* United States v. Sloan, 939 F.2d 499, 501 (7th Cir. 1991) ("'All individuals, natural or unnatural, must pay federal income tax' . . . regardless of whether they requested, obtained or exercised any privilege from the federal government") (citations omitted) (quoting Lovell v. United States, 755 F.2d 517, 519 (7th Cir. 1984); Benitez Rexach v. United States, 390 F.2d 631 (1st Cir. 1968) (rejecting claims of taxpayer whose U.S. citizenship was retroactively restored that during period of noncitizenship he owed no taxes because the United States owed him no protection).

income and accumulated wealth—under his control.[22] The principle of economic neutrality posits that the income tax should not interfere with the allocation of capital.[23] The U.S. income tax system embodies these principles by taxing only once increases in wealth and consumption. In addition, increases in wealth attributable to appreciated property are not taken into account until these gains have been realized.

Applying these principles to U.S. citizens and residents, worldwide income should be included in the tax base, since both U.S. and foreign source income equally affect a person's ability to pay. The taxation of the worldwide income of U.S. residents and citizens is also economically efficient, because it prevents taxation from affecting the allocation of capital. For example, if foreign source income were taxed at a lower rate than U.S. source income, U.S. taxpayers would have an incentive to shift capital abroad, and thereby distort the allocation of capital.[24]

2. *Nonresidents—Source and Trade or Business Basis Taxation*

In contrast to the U.S. taxation of its citizens and residents, nonresidents are subject to U.S. tax either on a source basis or on a trade or business basis. If a nonresident alien is not engaged in a U.S. trade or business, the U.S. taxes his U.S. source fixed, determinable, annual, and periodical ("FDAP") income at a flat thirty percent rate, which is collected by the payor.[25] Capital gains are not FDAP and are therefore

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22. JOSEPH M. DODGE ET AL, FEDERAL INCOME TAX: DOCTRINE, STRUCTURE AND POLICY 21 (1995).

23. *Id.* at 22.

24. This is referred to as capital export neutrality. *See* GARY HUFBAUER, U.S. TAXATION OF INTERNATIONAL INCOME: BLUEPRINT FOR REFORM 49-51 (1992). It is an extension of the economic neutrality norm. *See, e.g.*, JOSEPH M. DODGE, THE LOGIC OF TAX: FEDERAL INCOME TAX THEORY AND POLICY 287-90 (1989).

25. I.R.C. § 871(a)(1) (West 1989 & Supp. 1996). The types of income specifically enumerated in section 871(a)(1) are U.S. source interest (other than original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments. FDAP income also includes royalties, alimony, commissions, gambling winnings, and income on the surrender of a life insurance policy. *See* 3 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, ¶ 66.2.8 (2d ed. 1991 & Supp. 1996). In addition, gains from the sale of intangible property for contingent amounts, and, on the sale or exchange of an original issue discount obligation, the amount of the accrued but untaxed OID, are also taxed under section 871(a)(1). The 30 percent tax is called off for most interest received from U.S. sources and dividends from U.S. corporations with a substantial active foreign business activities. *See* I.R.C. § 871(h) (providing exemption for portfolio interest); § 871(i)(2)(A) (providing exemption for bank deposit interest); § 871(i)(2)(B) (providing exemption for certain dividends from U.S. corporations). Although wages, etc., are included under section 871(a)(1), the performance of services generally constitutes being engaged in a U.S. trade or business, and such payments are therefore subject to net basis taxation. *See* I.R.C. §§ 864(b), 871(b) (West 1989 & Supp. 1996). The withholding

not subject to U.S. tax, with the exception of gains realized on the disposition of U.S. real estate or gains that are treated as effectively connected with a U.S. trade or business.[26]

If a nonresident alien is engaged in a U.S. trade or business, the U.S. taxes the income that is effectively connected with the trade or business at graduated rates on a net basis.[27] Although effectively connected income consists generally of U.S. source income, a narrow category of foreign source income that has a strong economic nexus to the United States can be treated as effectively connected.[28]

Source and trade or business basis taxation tie taxation to the geographic origin of income. The theoretical basis for source and trade or business taxation is that the United States has provided the benefits that generated the income.[29] The fact that business income is taxed at graduated rates reflects both a desire to impose equal tax burdens on capital invested in the United States, whether owned by foreigners or U.S. persons, and also the necessity to tax accurately business income by allowing deductions for the expenses of earning the income. The flat rate taxation of FDAP income reflects the assumption that there are few or no expenses generally incurred in the production of such income and eases administrative burdens that would be caused by requiring

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provisions are set out in sections 1441-1446. I.R.C. §§ 1441-1446 (West 1989 & Supp. 1996).

26. I.R.C. § 897(a)(1) (West 1989 & Supp. 1996). Under § 871(a)(2), however, nonresident aliens present in the U.S. for 183 days or more are subject to the 30 percent tax on U.S. source capital gains.

27. I.R.C. §§ 2(d), 871(b)(1) (West 1989 & Supp. 1996) (stating that nonresident alien engaged in a U.S. trade or business is taxable under § 1 on his taxable income that is effectively connected with the U.S. trade or business). A nonresident alien will be engaged in a U.S. trade or business if her profit making activities are considerable, continuous and regular. *See* Pinchot v. Commissioner of Internal Revenue, 113 F.2d 718 (2d Cir. 1940). Once a nonresident alien is engaged in a U.S. trade or business, the rules for determining whether income is effectively connected are found in § 864(c) and the regulations thereunder. I.R.C. § 864(c) (West 1989 & Supp. 1996).

28. I.R.C. § 864(c)(4)-(6). For background on this provision, see Stanford G. Ross, *United States Taxation of Aliens and Foreign Corporations: The Foreign Investors Tax Act of 1966 and Related Developments*, 22 TAX L. REV. 279, 328-45 (1967).

29. Of course, there is no need for the United States to actually confer benefits. The United States has often refrained from taxing all U. S. source income of foreigners. This is due both to economic concerns—the United States needs to fund its deficits and wants to encourage investment in the United States—and administration—it would be difficult to enforce a tax on the transfer of U.S. securities, for example, if the securities were held abroad and the sale occurred between two foreign persons.

foreigners investing in passive U.S. assets to file U.S. tax returns setting forth applicable expenses.[30]

B. *Wealth Transfer Taxation: Federal Estate, Gift, and Generation Skipping Taxes*

1. *Citizens and Residents*

In addition to being subject to U.S. income tax on worldwide income, U.S. citizens and residents[31] are also subject to wealth transfer taxes[32] in the form of the estate tax on their worldwide taxable estates, the gift tax on worldwide taxable gifts, and the generation skipping tax on generation skipping transfers.

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30. The assumption that there are minimum expenses associated with earning FDAP income is questionable. To determine a nonresident's expenses associated with earning FDAP income, Congress or the Treasury would have to promulgate rules to distinguish between associated and nonassociated expenses. Developing a proper conceptual approach to use for determining whether an expense is associated with FDAP income or not, would not necessarily be an easy task. In certain activities, e.g., the passive rental of real estate, the disallowance of deductions against the rental income (an item of income subject to flat rate taxation under section 871(a)) would make the 30 percent tax confiscatory. Recognizing this, Congress has ameliorated the effect of flat rate taxation by allowing foreigners to treat rental income as effectively connected income. I.R.C. § 871(d).

31. Although not explicitly stated in the estate and gift tax regulations, citizenship is determined under the Immigration and Nationality Act, 8 U.S.C. §§ 1401-1459 (West 1989 & Supp. 1996), the same rules applicable to determine citizenship for income tax purposes. *See* Estate of Vriniotis v. Commissioner of Internal Revenue, 79 T.C. 298, 304-05 (1982); WILLIAM H. NEWTON, III, INTERNATIONAL INCOME TAX AND ESTATE PLANNING, § 3.49 (2d ed. 1994); RICHARD B. STEPHENS ET AL., FEDERAL ESTATE AND GIFT TAXATION, ¶ 6.01[2] (6th ed. 1991 & Supp. 1995). The term "resident" for estate and gift tax purposes is not coterminous with its meaning for income tax purposes. For estate and gift tax purposes, a resident is an individual who was domiciled in the U.S. at the time of death or the gift. This definition is similar but not identical to the definition of residence for income tax purposes prior to 1984. It was and still is possible to be a resident for income tax purposes but not for transfer tax purposes. For a discussion of the factors that determine an individual's domicile, see ROBERT C. LAWRENCE III, INTERNATIONAL TAX AND ESTATE PLANNING: A PRACTICAL GUIDE FOR MULTINATIONAL INVESTORS 103-06 (2d ed. 1989).

32. A complete discussion of the U.S.wealth transfer tax regime is beyond the scope of this article. Comprehensive discussions can be found in 5 BITTKER & LOKKEN, *supra* note 25, ¶ 120-36; NEWTON, *supra* note 31; STEPHENS, *supra* note 31. The U.S. wealth transfer tax system has been recently subject to illuminating analyses. *Compare* Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, 104 YALE L. J. 283 (1994) (arguing for the repeal of estate and gift taxes) *with* Mark L. Ascher, *Curtailing Inherited Wealth*, 89 MICH. L. REV. 69 (1990) (calling for abolition of inheritance). A debate of the merits or shortcomings of the current U.S. wealth transfer system is beyond the scope of this article.

A U.S. decedent's gross estate includes the value at death of all property wherever situated.[33] If foreign property were excluded, not only would U.S. persons have an incentive to invest abroad, thereby distorting the allocation of capital, but the estate tax base would be quickly eroded.[34] The estate tax is levied on an individual's taxable estate, which is the gross estate less statutory deductions,[35] the most important deduction being that for the value of any property passing to a surviving spouse.[36] The marital deduction reflects the policy of treating husband and wife as one economic unit for estate tax purposes, thereby ensuring the property owned by either spouse or jointly is not subject to the estate tax until the property passes from the surviving spouse.[37] The marital deduction is disallowed, however, if the surviving spouse is not a U.S. citizen.

Since 1932, the United States has taxed its citizens and residents on the transfer by gift of property wherever located.[38] The gift tax is the analogue to the estate tax and was enacted to prevent avoidance of the estate tax through lifetime rather than at death transfers of property. For purposes of the gift tax, the scope of the term property is all-encompassing, and includes direct and indirect transfers.[39]

The gift and estate tax rates vary from eighteen to fifty-five percent.[40] A credit of $192,800 against taxable gift and estates is avail-

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33. I.R.C. §§ 2031(a), 2033 (West 1989).

34. Property is broadly defined. *See* Treas. Reg. § 20.2033-1(a) (as amended in 1963). The gross estate also includes the value of property transferred to another person or entity but over which the decedent maintained some power. Such property includes: property transferred with a retained life estate, I.R.C. § 2036 (West 1989 & Supp. 1996); property transfers taking effect at death, I.R.C. § 2037 (West 1989 & Supp. 1996); revocable transfers, I.R.C. § 2038 (1996); and certain survivor annuities, I.R.C. § 2039 (West 1989 & Supp. 1996).

35. I.R.C. § 2051 (West 1989).

36. I.R.C. § 2056(a) (West 1989 & Supp. 1996). Terminable interests—the transfer of Property A by decedent to spouse for life with a remainder interest to the couple's children—interests do not qualify for the marital deduction. I.R.C. § 2056(b)(1). Otherwise, property could be transferred from the family unit free of transfer tax. *See* STEPHENS, *supra* note 31, ¶ 5.06[7].

37. 5 BITTKER & LOKKEN, *supra* note 25, ¶ 129.1 (citing S. REP. NO. 144, at 125 (1981), *reprinted* in 1981-2 C.B. 412, 461).

38. I.R.C. § 2501(a)(1) (1989 & Supp. 1996).

39. I.R.C. § 2511(a) (West 1989).

40. I.R.C. § 2001(c)(1) (1989 & Supp. 1996). The lower rates are phased out for gifts and taxable estates in excess of $10 million. *See* I.R.C. § 2001(c)(2). Since 1976, U.S. estate and gift taxes have been unified, and, as a consequence, lifetime gifts are

able.[41] This credit effectively shelters the first $600,000 of taxable gifts or estate from tax. A gift tax deduction is allowed for gifts to spouses,[42] unless the spouse is a non-citizen. In such case, up to $100,000 can be transferred annually free of gift tax to a noncitizen spouse.[43]

The generation skipping tax has applied to generation skipping transfers of U.S. citizens and residents since 1986.[44] Just as the gift tax serves to prevent the erosion of the estate tax base by inter-vivos gifts, the generation skipping tax was enacted to ensure that an estate or gift tax is imposed at least once at every generation. A prototypical gambit at which the generation skipping tax is aimed consists of a transfer of property by parents in trust with a life estate to children and a remainder interest to grandchildren. Because the termination of the children's interest in the trust is not includable in their estate or subject to gift tax, this arrangement had the effect of transferring wealth from the parents to the grandchildren with the imposition of estate tax only once. In contrast, had the parents bequeathed the property to their children, who in turn, bequeathed it to their children, the property would have been included in the parent's and children's gross estates.[45]

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aggregated with at-death transfers and a single, progressive rate applies to both amounts. I.R.C. § 2001; I.R.C. § 2502 (West 1989). The aim of the unified rate schedule is roughly to equalize the aggregate transfer tax paid on lifetime and at-death transfers. There are, however, several differences between gift and estate taxes that favor in many instances lifetime gifts over at death transfers, e.g., the $10,000 annual exclusion, split gifts, and the fact that the gift tax is levied on a tax exclusive basis. For a description of some of the other differences between the estate and gift tax, see 5 BITTKER & LOKKEN, *supra* note 25, ¶ 132.1. In the international context, there is a potentially significant difference that may favor at death transfers over lifetime transfers: no credit is given against U.S. gift or generation skipping tax for foreign gift or generation skipping taxes. Pursuant to estate tax treaties, however, such taxes may be creditable.

41. I.R.C. § 2010(a) (West 1989 & Supp. 1996).

42. I.R.C. § 2523(a) (West 1989 & Supp. 1996).

43. I.R.C. § 2523(i)(1)-(2). Certain amounts may be transferred free of gift tax, such as the annual exclusion of $10,000 per donee, and transfers for educational and medical expenses. I.R.C. § 2503(b), (e) (West 1989 & Supp. 1996).

44. A prior version of the generation skipping tax was enacted in 1976, but was retroactively repealed and substituted by the current version in the Tax Reform Act of 1986. Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 1431-1433, 100 Stat. 2717-2732 (1986), *reprinted in* 1986-3 C.B. 1, 634-49.

45. Since the goal of the generation skipping tax is to equalize approximately the transfer tax treatment of generation skipping transfers with actual transfers from one generation to the next, it may be inappropriate to impose generation skipping taxes on transfers where the skipped generation is not a U.S. resident or citizen. Under the prior version of the generation skipping tax, some of account was given to the tax status of the skipped generation. When the "deemed transferor"—generally a member of the intermediate generation—was a nonresident alien, only U.S. situs assets at the time beneficial interest shifted from deemed transferor to the next generation were subject to the generation skipping tax. D. Chase Troxell, *Aliens—Estate, Gift and Generation-*

The generation skipping tax is levied on taxable distributions, taxable terminations, and direct skips.[46] Each person is permitted a lifetime exemption of one million dollars for generation skipping transfers.[47] Transfers in excess of one million dollars are subject to tax at the maximum federal estate tax rate, currently fifty five-percent.[48]

2. *Nonresident Aliens*

The United States subjects nonresident aliens to U.S. wealth transfer taxes with respect to certain U.S. situs property.[49] Nonresidents are subject to U.S. estate tax on U.S. situs property on the date of death.[50] U.S. situs property includes stock of a U.S. corporation,[51] U.S. real property,[52] and tangible personal property located in the United

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Skipping Taxation, TAX MGMT. (BNA) 201-4th (1991), at A-20 (1991). This approach was abandoned when the current version of the generation skipping tax was enacted.

46. I.R.C. § 2611(a) (West 1989). A direct skip is a transfer to a person two or more generations below the transferor ("skip person") or to a trust if all interests in the trust are held by skip persons. I.R.C. §§ 2612(c)(1), 2613(a)(1) (West 1989). A taxable termination is the termination of an interest in property in trust, whether by death, lapse of time, release of power, or otherwise, unless a non-skip person continues to have an interest in the trust property or at no time after such termination can a distribution be made to a skip person. I.R.C. § 2612(a)(1). A taxable distribution is a distribution from a trust to a skip person that is not a taxable termination or direct skip. I.R.C. § 2612(b).

47. I.R.C. § 2631(a) (West 1989).

48. I.R.C. § 2641(a) (West 1989).

49. For a thorough discussion of current issues relating to the transfer taxation of nonresidents, see Cynthia Blum, *U.S. Transfer Taxation of Nonresident Aliens: Too Much or Too Little?*, 14 U. PA. J. INT'L BUS. L. 469 (1994).

50. I.R.C. § 2103 (West 1989). If any property was transferred during a decedent's lifetime and is covered by sections 2035-2038, such property will be treated as U.S. situs if it was U.S. situs either at the time of the transfer or at death. I.R.C. § 2104(b) (West 1989). To arrive at the taxable estate, statutory deductions are computed in the same manner as for citizens and residents, but since only the U.S. portion of the nonresident's estate is subject to U.S. tax, only a ratable portion of the worldwide expenses are deductible. The marital deduction is allowed, but only if the surviving spouse is a U.S. citizen or the property is bequeathed to a qualified domestic trust. I.R.C. § 2106(a)(3) (West 1989).

51. I.R.C. § 2104(a). This rule probably catches property more by inadvertence or faulty advice as it is easily avoided by merely holding the shares in a foreign corporation. *But see* Fillman v. United States, 355 F.2d 632 (Ct. Cl. 1966) (holding that decedent can be taxed on shares of U.S. corporations held by foreign corporation where corporate formalities are not observed). Although the IRS periodically threatens to use *Fillman* to pierce foreign corporations, to date, there have been no other cases in which the IRS has been successful.

52. Treas. Reg. § 20.2104-1(a)(1) (as amended in 1973).

States.[53] Conversely, stock of a foreign corporation, foreign real property, tangible property located outside of the United States, and proceeds of life insurance on the life of a nonresident alien are foreign situs.[54] For intangible property other than stock or debt, e.g., a patent, the regulations provide that it will be U.S. situs if (1) the written evidence of the property is not treated "as being the property itself" and (2) the intangible "is issued by or enforceable against" a U.S. resident, domestic corporation, or governmental unit.[55] Because stock of foreign corporations is foreign situs, U.S. estate tax is easily avoided merely by holding any U.S. situs property in foreign corporate solution.

Nonresident aliens are subject to gift tax on gratuitous transfers of tangible—both real and personal—property that is U.S. situs, but not with respect to intangible property.[56] Thus, a nonresident alien can transfer stock of a U.S. corporation free of U.S. gift tax, even though the stock would have been includable in her gross estate.[57]

In computing a nonresident's U.S. gift tax liability, no unified credit is permitted. Thus, for even the smallest gifts (in excess of allowable deductions), the applicable gift tax rate begins at eighteen percent. The estate tax computation for nonresidents follows that of citizens and residents except that a credit of $13,000 is allowed,[58] which has the effect of exempting the first $60,000 of taxable estate from U.S. tax.

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53. Treas. Reg. § 20.2104-1(a)(2). The situs of a partnership interest for estate and gift tax purposes is unclear. For a discussion of the underlying issues and authorities, see Blum, *supra* note 49, at 522-23.

54. Treas. Reg. § 20.2105-1(a)(1)-(2), (f), (g) (as amended in 1974). The situs of debt generally depends on the residence of the obligor. I.R.C. § 2104(c). Even if the obligor is a U.S. person, if interest on the debt would not be subject to U.S. income tax, the debt will be treated as foreign situs. I.R.C. § 2105(b)(1) (West 1989 & Supp. 1996). This rule probably reflects a desire to encourage foreign persons to hold U.S. debt.

55. Treas. Reg. § 20.2104-1(a)(4). If the intangible property is treated "as being the property itself," the regulations do not prescribe its situs. 5 BITTKER & LOKKEN, *supra* note 25, ¶ 134.2.3, point out the unartfulness of the drafters: "[I]f the tangible 'written evidence' is the 'property itself,' the property is tangible, not intangible." *Id.* As an example of such an intangible, beside bearer bonds, that may be covered by section 2105(b), they suggest either a lottery ticket, bearer stock rights or warrants. *Id.*

56. I.R.C. § 2501(a)(1) imposes U.S. gift tax on the transfer of property by gift by any individual, both resident and nonresident. I.R.C. § 2501(a)(2) calls off the gift tax for nonresident aliens with respect to intangible property, and I.R.C. § 2511(a) (West 1989) limits taxable transfers of nonresident aliens to transfers of U.S. situs property.

57. Like citizens and residents, nonresidents are eligible for the $10,000 per donee annual exclusion under I.R.C. § 2503(b) (1989 & Supp. 1996) as well as the exclusion for transfers for educational expenses or medical expenses under I.R.C. § 2503(e). Like citizens, nonresidents can transfer by gift an unlimited amount of property free of gift tax to a citizen spouse under section 2523(a), but no deduction is permitted for transfers to noncitizen spouses. I.R.C. § 2523(i) (West 1989). For transfers by gift to noncitizen spouses, however, the $10,000 per donee annual exclusion is increased to $100,000. *Id.*

58. I.R.C. § 2102(c)(1) (West 1989).

Under regulations issued in 1996,[59] nonresidents are subject to the generation skipping tax only to the extent that the initial generation skipping transfer of property would have been subject to either U.S. estate or gift tax. The nonresident estate tax situs rules apply to at-death transfers, and the nonresident gift tax situs rules apply to inter-vivos transfers. The citizenship or residency of the transferor's descendants is irrelevant.[60]

C. *Income and Wealth Transfer Tax Treaties*

Even if a nonresident alien is subject to U.S. income or wealth transfer taxes, this liability may be reduced or eliminated by provisions of bilateral income and estate, inheritance, and gift tax treaties.[61] The most important function of treaties is to mitigate international double taxation.[62] Income tax treaties accomplish this generally by the source country reducing or eliminating taxes on income earned by a resident (as defined in the applicable treaty) of the other treaty signatory.[63] For example, the U.S. imposes a thirty percent tax on royalties paid to a nonresident for use of intangible property in the U.S. If the nonresident

59. 60 Fed. Reg. 66898 (1996). The generation skipping tax can be applied to direct skips of U.S. situs property by nonresidents even prior to the issuance of the regulations. *See* Estate of Neumann v. Commissioner of Internal Revenue, 106 T.C. 216, 221 (1996).

60. Under proposed regulations issued in 1992, the generational skipping tax was to apply to transfers of property that was U.S. situs for either estate or gift tax purposes. Prop. Treas. Reg. § 26.2663-2(b), 60 Fed. Reg. 66898 (1996). In addition, the generation skipping tax was to have applied to transfers of foreign situs property if a beneficial interest passed to a skipped person who was a U.S. citizen or resident, and at the time of the initial transfer, a lineal descendant of the transferor was a U.S. person. *Id.* This last rule was criticized and deleted in the final regulations. *See, e.g.*, NYSBA, *Report on Proposed Regulations Relating to the Generation Skipping Tax*, Apr. 19, 1993, *reprinted in* Highlights & Documents, Apr. 27, 1993; Richard L. Doernberg & Jeffrey N. Pennell, *Application of the Generation-Skipping Transfer Tax in an International Setting*, TAX NOTES INT'L 723, 727-28 (Mar. 22, 1993).

61. As of May, 1996, the U.S. is signatory to income tax treaties with 58 countries and wealth transfer tax treaties with seventeen countries. A readily available source containing a current listing of the tax treaties currently in force and the status of treaty negotiations is the monthly TAX MANAGEMENT INTERNATIONAL JOURNAL.

62. *See* A.L.I., Federal Income Tax Project: International Aspects of the United States Income Taxation, Proposals on United States Income Tax Treaties, 5-8 (1987).

63. For a discussion of the competing tax and economic interests of countries that influence and shape provisions of income tax treaties, see Charles I. Kingson, *The Coherence of International Taxation*, 81 COLUM. L. REV. 1151 (1981).

is a resident of a treaty country, the thirty percent tax is generally eliminated.[64] If, under the terms of a treaty, the source country may tax an item of income, treaties often mandate that the residence country cede its taxing jurisdiction over such item of income by granting a credit for foreign taxes levied by the source country.

In more recent wealth transfer tax treaties,[65] the source country reduces or eliminates situs basis estate and gift taxation for domiciles of the other treaty country, except for a narrow category of assets that the situs country may continue to tax. Double taxation is avoided by providing domicile tie-breaker rules, which operate to assign only one fiscal domicile, and requiring the domiciliary country to grant a credit for the situs tax imposed.[66]

D. The Protection of Residence Basis Taxation

1. Income Tax

In order to protect residence basis taxation, Congress has enacted a panoply of provisions that prevent U.S. taxpayers from using foreign corporations to thwart residence basis taxation. Because foreign corporations, like nonresident aliens, are subject to U.S. income tax only on a source or trade or business basis,[67] in the absence of these special provisions, a U.S. taxpayer could transfer appreciated or income producing property to a foreign corporation, and the corporation could

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64. *See, e.g.*, Income Tax Convention, Dec. 18, 1992, U.S.-Neth., S. Treaty Doc. No. 6, 1993, *reprinted in* 32 I.L.M. 462, art. 13 (1993) [hereinafter Dutch Treaty].

65. Estate and gift tax treaties can be divided into two groups: pre-Organization for Economic Cooperation and Development (OECD) treaties and those that follow the OECD model transfer tax treaty. The older pre-OECD treaties focus primarily on the situs of assets, and avoid double taxation by providing a specific situs for most types of assets, and permitting only the country of situs the right to tax those assets. 5 BITTKER & LOKKEN, *supra* note 25, ¶ 134.2.7. For a discussion of how specific assets were generally assigned a situs, see NEWTON, *supra* note 31, § 5.42-46. In addition, once the situs of assets has been assigned by a treaty, double taxation is further relieved by a credit mechanism under which when one or both countries tax on the basis of personal status—citizenship or domicile—the taxes of the situs country must be creditable against the taxes of the country of domicile.

66. Because under so-called savings clauses of treaties, the U.S. generally reserves the rights to tax its citizens and domiciliaries, the U.S. may tax its citizens even though they have become domiciliaries of another country. In such cases, OECD-type treaties generally treat the domiciliary country taxes as primary and require the U.S. to grant a credit against its taxes imposed on the basis of citizenship. *See* NEWTON, *supra* note 31, § 5.49, at 5-122. For a more detailed discussion of the OECD-type treaties, see *id.*, § 5.47.

67. A foreign corporation engaged in a U.S. trade or business is also subject to the branch profits tax of I.R.C. § 884 (1988 & Supp. 1996).

sell the property free of U.S. tax, or collect the income free of U.S. tax if the property produced foreign source income. Any income could be retained by the corporation, and no U.S. tax would be due until the income were distributed to shareholders. Thus, by transferring property to a foreign corporation, not only could a U.S. taxpayer obtain deferral of all U.S. income tax attributable to the gain or income realized with respect to such property, but the deferral could also become permanent if the property or income were held in foreign corporate solution and the shares of the foreign corporation were transferred at death to another U.S. beneficiary.[68] Through the creative use of foreign corporations, residence basis taxation could be avoided at will, and the U.S. tax base could be seriously eroded.

Over the last sixty years, Congress has enacted an array of provisions to prevent taxpayers from exploiting the separate taxation of shareholders and corporations, both in the international and domestic contexts. These provisions include (in order of their enactment) the accumulated earnings tax ("AET"), the personal holding company ("PHC") and foreign personal holding company ("FPHC") provisions, the foreign investment company ("FIC") provisions, the controlled foreign corporation ("CFC") provisions, and most recently, the passive foreign investment company ("PFIC") provisions.[69] In essence, these provisions protect the progressive rate structure and residence basis taxation by generally taxing certain income of the corporation to its U.S. shareholders. Although each provision is slightly different in scope, the income sought to be taxed currently is generally of a passive type. For example, dividends and interest are taxed, but not business income, even if the sole reason to conduct business through a foreign corporation is to avoid current U.S. tax.

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68. For a discussion of some of the schemes used by taxpayers to avoid U.S. taxation by moving property outside of U.S. taxing jurisdiction, see H.R. REP. NO. 708, at 20 (1932).

69. I.R.C. §§ 532-537 (West 1988 & Supp. 1996) (AET); I.R.C. §§ 541-547 (West 1988 & Supp. 1996) (PHC); I.R.C. §§ 551-558 (West 1988 & Supp. 1996) (FPHC); I.R.C. §§ 951-964 (West 1988 & Supp. 1996) (CFC); I.R.C. §§ 1246-1247 (1988 & Supp. 1996) (FIC); and I.R.C. §§ 1291-1297 (PFIC) (West 1988 & Supp. 1996). A detailed discussion of these provisions is beyond the scope of this article, but can be found in JOSEPH ISENBERGH, INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN TAXPAYERS AND FOREIGN INCOME ¶ 27 (2d ed. 1996).

Related to the provisions that tax the income of a foreign corporation to its U.S. shareholders are the rules under section 367(a).[70] These provisions protect residence basis taxation by ensuring that gain on appreciated property that is transferred outside of the U.S., for example, to a foreign corporation, is taxed upon the transfer, regardless of any otherwise applicable nonrecognition provision.[71] An exception applies, however, for property used in an active foreign trade or business.[72] An analogous provision—section 1491—imposes a thirty-five percent excise tax on the appreciation inherent in property transferred by a U.S. person to a foreign trust, foreign partnership, or a foreign corporation as paid-in surplus or as a contribution to capital.[73]

Two other provisions also protect residence basis taxation against abusive uses of foreign corporations. Under section 367(d), the outbound transfer of any intangible property that would otherwise be tax free is treated as a sale for contingent payments based on the productivity or use of the property, and the U.S. transferor must include, in annual income, amounts that are commensurate with income attributable to the property.[74] Section 367(d) is intended to prevent a taxpayer from

70. I.R.C. § 367(a) (West 1988 & Supp. 1996).

71. *Id.* Technically, the statute operates by not treating the transferee foreign corporation as a foreign corporation for purposes of certain reorganization provisions, under which the status of the foreign transferee as a corporation is a sine qua non of tax-free treatment for the transferor. For purposes of recognizing loss, however, the corporate status of the foreign transferee is respected. *Id.*

72. I.R.C. § 367(a)(3)(A); Treas. Reg. § 1.367(a)-2T (1986). Certain property, *e.g.*, inventory, accounts receivable, foreign currency, intangible property, is not eligible for the active trade or business exception and gain (but not loss) is recognized upon transfer. I.R.C. § 367(a)(3)(B)(i)-(v); Treas. Reg. § 1.367(a)-5T (1986). Even for property that is eligible for the active trade or business exception, the transferor must recapture depreciation for property that has been used in the U.S. to the extent the property's value exceeds its adjusted basis. Treas. Reg. § 1.367(a)-4T (1994). Special rules are applicable to the outbound transfers of stock and securities, which link gain recognition to the amount of stock of the foreign transferee held by U.S. transferors. *See* Prop. Treas. Reg. § 1.367(a)-3; 56 Fed. Reg. 41993-41995 (1991).

73. I.R.C. § 1491 (West 1988) has remained relatively unchanged since its enactment in 1932. In 1976, Congress amended section 1491 to provide that it would apply to all property transferred, rather than to only stock or securities. In addition, transfers "described in section 367" or transfers with respect to which the taxpayer applied "principles similar to the principles of section 367" are exempted from section 1491. I.R.C. § 1492(2)(A)-(B) (West 1988 & Supp. 1996). In the same legislation, Congress also permitted U.S. transferors to elect to recognize gain at the time of transfer under I.R.C. § 1057 (West 1988). The advantage of a section 1057 election or an application of the principles of section 367 is that the gain is potentially taxable at more favorable capital gains rates, and a taxpayer receives a step up in basis in the property subject to tax.

74. I.R.C. § 367(d) is unnecessarily draconian as the deemed payments from the foreign corporation are treated as U.S. source income, thus precluding the use of any foreign tax credits against such income.

deducting against U.S. income the development costs of intangible property, and earning the income from the profitable intangible in a foreign corporation controlled by the developer of the property. Similarly, under section 367(a)(3)(C), U.S. taxpayers must recapture previously deducted foreign branch losses when a branch is incorporated to the extent of any gain realized upon incorporation.[75]

Other Code provisions also protect residence basis taxation. Section 1041(e) provides that transfers of property to a nonresident alien spouse are not eligible for the nonrecognition rule under section 1014(a), which provides for gift treatment of all transfers between spouses.[76] Section 1014(a) thus defers the taxation of any built-in gain of property transferred between spouses until the property is sold or exchanged. Congress did not grant section 1041(a) treatment where the property was transferred to a nonresident spouse, apparently on the rationale that the appreciation would not be taxed upon a subsequent sale by the nonresident spouse.[77]

Prior to 1989, it was possible to exchange appreciated U.S. real property for foreign real property without the recognition of gain, provided the requirements under section 1031 were satisfied. Section 1031(h), enacted in 1989, prevents such tax-free transfers by providing that U.S. real estate and foreign real estate are not like-kind property, a sine qua non of nonrecognition treatment under section 1031(a).[78] This provision was primarily enacted to curb the abuse of improperly inflating the foreign source income of U.S. persons by exchanging U.S. real property for foreign property and subsequently selling the foreign property, thereby generating foreign source income under section 862(a)(5).[79] For residents, the provision also protects residence basis taxation. Before the enactment of section 1031(h), a resident alien could exchange U.S. real property for foreign real property tax-free under section 1031(a). Upon becoming a nonresident alien, the former resident

75. I.R.C. § 367(a)(3)(C); Treas. Reg. § 1.367(a)-6T (1986).
76. I.R.C. § 1041(e) (West 1988 & Supp. 1996).
77. I.R.C. § 1041(d). Section 1041(d) can be criticized. A transfer to a citizen spouse does not necessarily imply that built-in gain will be recognized; the property could be held until death at which time the decedent's heir would take a fair market value basis in the property under section 1014, or the resident alien can remove the property from U.S. residence basis taxation merely by surrendering her U.S. residency.
78. I.R.C. § 1031(a) (1989 & Supp. 1996).
79. I.R.C. § 862(a)(5) (1988 & Supp. 1996).

alien could sell the foreign property free of U.S. income tax. This can still be accomplished under section 1034 with respect to personal residences,[80] and under section 1031 with respect to personal property not disqualified under section 1031(a)(2).[81]

2. Wealth Transfer Taxes

In 1988, Congress enacted a special provision to address the movement of property outside U.S. transfer tax jurisdiction either at death or by inter-vivos gratuitous transfers to non-citizen spouses. The underlying policy of the U.S. transfer tax regime with respect to married couples is to treat the marital unit as one person and to impose transfer taxes once, when property leaves the estate of the last surviving spouse. To implement this policy, marital bequests to a surviving spouse qualify for an unlimited marital deduction, and gifts to a spouse likewise qualify for an unlimited gift tax deduction. This deduction, however, is not available if the transferee spouse is a non-citizen, although the annual exclusion is raised to $100,000 for inter-vivos gratuitous transfers to non-citizen spouses.[82]

The rationale for denying the marital deduction for transfers to a non-citizen spouse is that the property may not be taxed when the surviving spouse dies unless the spouse is a U.S. resident at death. Congress

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80. *See* Rev. Rul. 71-495, 1971-2 C.B. 311 (resident alien who sold U.S. principal residence, returned to Norway to reside permanently, and brought replacement residence in Norway within one year of sale, was eligible for section 1034 nonrecognition treatment on sale of U.S. property). In legislation vetoed by President Clinton in 1995, section 1034 would have been amended to provide that foreign property purchased by a resident alien would not be eligible for nonrecognition treatment under section 1034. Revenue Reconcilliation Act of 1995, H.R. 2491, 104th Cong. § 11322.

81. I.R.C. § 1031 (a)(2) (West 1989 & Supp. 1996). Although stocks, bonds, partnership interests, and inventory are not eligible for section 1031 treatment, many types of valuable property are potentially eligible for section 1031 treatment, for example, intangible property. *See* Treas. Reg. § 1.103 1(a)-2(b)(2) Ex. (1) (1960).

82. I.R.C. § 2056(d)(1)(B) (disallowance of marital deduction to non-citizen spouse for estate tax purposes); I.R.C. § 2523(i)(1)-(2) (West 1989 & Supp. 1996) (disallowance of gift tax deduction to transfers to non-citizen spouse). A related provision calls off the application of section 2040(b), under which one half of the value of property jointly by spouses with a right of survivorship is included in the estate of the first spouse to die. I.R.C § 2056(d)(1)(B) (1989 & Supp. 1996), This rule applies regardless of which spouse provided the consideration. In such cases, the rules of section 2040(a), under which the first to die must include in her estate the value of jointly owned property, will apply, except to the extent that the surviving spouse contributed to the cost of the acquisition of the property. *See* STEPHENS, *supra* note 31, ¶ 4.12. Special rules are also applicable to the creation of joint tenancy between husband and wife with the right of survivorship or a tenancy by the entirety when one spouse is a non-citizen. *See* I.R.C. § 2523(i)(3) ("[T]he principles of sections 2515 and 2515A (as such sections were in effect before their repeal by the Economic Recovery Tax Act of 1981) shall apply . . . ."). This provision is certainly not a model of clear statutory drafting, to say the least.

believed that since it is relatively easy to divest oneself of U.S. residency for transfer tax purposes, the surviving spouse could easily avoid subsequent U.S. transfer taxes by becoming a nonresident for transfer tax purposes, and thereby thwarting the policy to tax transfers of wealth when the property passes from the surviving spouse.[83]

These rules do not necessarily equalize the aggregate transfer taxes paid by couples where both are U.S. citizens as compared to couples where the surviving spouse is a non-citizen. When both spouses are citizens, any part of the transferred estate that is consumed will not incur any further transfer taxes.[84] When the surviving spouse is a non-citizen, however, the transferred estate can be consumed only after estate taxes are paid, except in the rare case of hardship distributions under section 2056A(b)(3)(B).[85]

For gifts made by a married person to someone other than his spouse, an election can be made to treat the gift as made one-half by each of them rather than as made individually.[86] This election, however, is not available unless both spouses are either U.S. citizens or residents at the time of the gift.[87] This provision also protects residence basis transfer taxation. For example, assume that John, a U.S. citizen, is married to Juanna, a nonresident, and transfers stock of a foreign corporation worth one million dollars to a U.S. taxpayer. If the election under section 2513 were permitted, one million dollars would have left John's estate, but only $500,000 would be taxable. By requiring that both spouses be residents or citizens, section 2513 ensures that the entire amount of property leaving the estate of the transferor is taxed.[88]

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83. H.R. REP. NO. 795, 100th Cong., at 592 (1988). Pursuant to section 2056(d)(2), transfers to a qualified domestic trust ("QDT"), as defined in section 2056A, qualify for the marital deduction for estate tax purposes. I.R.C. § 2056(d)(2) (West 1989 & Supp. 1996). Upon the distribution of principal from the trust or property constituting principal remaining in the trust on the date of the death of the surviving spouse, estate tax is levied. The QDT regime defers payment of the estate tax until the surviving spouse's death. *Id.*

84. One commentator has argued that the ability to consume wealth free of transfer tax is analogous to a tax expenditure, that is, the government in essence provides a subsidy equal to the transfer tax foregone on the consumed wealth. *See* McCaffery, *supra* note 32.

85. I.R.C. § 2056(b)(3)(B).

86. I.R.C. § 2513(a) (West 1989).

87. *Id.*

88. With the enactment of I.R.C. § 2523(i) (West 1989 & Supp. 1996), which denies the marital deduction for transfers to non-citizen spouses, section 2513(a) should

3. *Income Tax Treaties*

Under treaties, once a person satisfies the definition of resident or domicile, he may avail himself of treaty benefits. To protect U.S. residence basis taxation, however, all treaties contain a provision that does not permit U.S. citizens and residents who are residents of another country to use the treaty to reduce U.S. taxes. These provisions, denominated "savings clauses," typically provide that the United States may tax its residents and nationals as if the treaty had not come into effect. Importantly, more modern U.S. treaties define a U.S. national to include a former U.S. citizen for a ten-year period following the loss of citizenship if the loss of U.S. citizenship was tax motivated.[89] These provisions incorporate section 877 and have the effect of ensuring that a former citizen who expatriated for tax-motivated purposes may not use the treaty to reduce U.S. income taxation.[90]

E. Summary

This part has outlined the U.S. income and wealth transfer tax regimes applicable to citizens, residents, and nonresidents. Generally, the United States taxes the worldwide income, gifts, estates, and generation skipping transfers of its citizens and residents. In order to protect residence basis taxation from taxpayers transferring appreciated property outside of the United States, Congress has enacted provisions that require U.S. taxpayers to recognize gain upon the transfer of appreciated property outside of U.S. residence basis taxation and to continue to pay tax on the income produced by the transferred property. In the transfer tax area, Congress has eliminated the marital deduction for transfers to non-citizen spouses in order to prevent the wealth of U.S. persons from potentially being transferred tax free out of the United States.

Nonresident aliens are subject to U.S. income tax only on U.S. source FDAP income and trade or business income, and to U.S. transfer tax on transfers of U.S. situs property. U.S. transfer taxes are easily avoided by holding U.S. situs property in foreign corporate solution. Further-

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be amended to prevent the election unless both spouses are citizens, or if the spouse is a resident alien, the amount of property eligible for the election should perhaps be limited to $200,000 per year.

89. *See, e.g.*, Dutch treaty, *supra* note 64, art. 24, ¶ 1.

90. Under the Dutch treaty, however, if the former citizen has become a citizen of the Netherlands, the savings clause would not be applicable, regardless of whether the expatriation of the former citizen was tax motivated. *Id.*

more, U.S. income and wealth transfer tax liability may be reduced or eliminated by income and wealth transfer tax treaties.

III. THE CHALLENGE EXPATRIATION POSES TO RESIDENCE BASIS TAXATION AND A MARK-TO-MARKET SYSTEM FOR TAXPAYERS CHANGING U.S. TAX STATUS

As the above discussion of residence and source basis taxation illustrates, it is generally more advantageous to be taxed on a source or trade or business basis than on a residence basis, both with respect to U.S. income and wealth transfer taxes. For example, assume that John, a U.S. citizen, owns stock of IBM that has a cost basis of one million dollars and a fair market value of eleven million dollars. If John sells the stock while a citizen for eleven million dollars, and assuming a U.S. capital gains tax rate of twenty-eight percent, the United States will collect income tax of approximately 2.8 million dollars. Furthermore, upon the transfer to his heirs of the remaining 8.2 million dollars, there will be levied an estate tax of approximately $4.18 million,[91] for a total lifetime U.S. tax liability of $6.98 million. Alternatively, if John held the stock until death, there would be no income tax liability on the accrued gain. This arises because death is not a realization event, and under section 1014,[92] John's heirs would receive the property with a fair market value basis. The transfer of the eleven million dollars of stock to his heirs would bring with it a U.S. estate tax liability of $5.72 million.[93] Further variations on this theme are possible, but the general tax consequences for U.S. persons remain invariable: Gains are generally taxed if realized during a taxpayer's lifetime, and what remains after income tax will be subject to transfer taxes if not consumed; unrealized gains escape income taxation at death, but constitute part of the gross estate for transfer tax purposes.

If John were a nonresident alien, however, his fiscal contribution to the United States would be significantly less. The sale of the stock

91. This is calculated as follows: $8.2 million less the $600,000 exemption multiplied by 55%. Of course, this is only a very rough approximation of John's U.S. income and transfer tax liability.
92. I.R.C. § 1014 (West 1989).
93. This is calculated as follows: $11 million less the $600,000 exemption multiplied by 55%.

would generally be free of U.S. income tax,[94] and the proceeds could be transferred to his heirs free of U.S. estate (or gift tax), even if they consisted of U.S. bank deposits. Again, different outcomes are possible. For example, if John died and directly owned the IBM stock, it would be included in his U.S. gross estate. Because the U.S. estate tax could be avoided, however, merely by holding the stock in foreign corporate solution or passing to his heirs free of gift tax, the estate tax liability is realistically only a remote possibility.

As this example illustrates, the U.S. tax savings that can inure to a person going from being taxed on a residence basis to being taxed on a source basis are considerable.[95] The issue therefore arises: How should such persons be taxed?

Expatriation poses two challenges to our income tax system: (1) how to tax accrued but unrecognized gains that may escape U.S. taxation by a person moving from residence to source basis taxation because of the realization principle; and (2) how to tax subsequently earned income that the United States will not tax (or tax at a lower rate) because the person is no longer taxed on a residence basis.[96] Some might argue the Untied States should care about all of the future U.S. taxes that an expatriate would have paid had he remained subject to U.S. residence taxation. This argument should be rejected because our current income tax system taxes only the income of nonresidents that has some economic nexus with the United States, and the foreign source income of nonresidents (even expatriate nonresidents) has no nexus with the United States. In addition, such exertion of taxing authority would conflict with international tax norms reflected in our income tax treaties. Finally, there would be no way realistically to collect such taxes. Thus, the real challenge is how to tax accrued but unrecognized gains at the time of expatriation.

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94. The sale of stock would be taxable only if John were engaged in a U.S. trade or business and the gain was treated as effectively connected. Because it would be foreign source under section 865 in any case, it rarely would be treated as effectively connected. *See* I.R.C. § 864(c)(4)-(6) (West 1988 & Supp. 1996).

95. This is only a very rough approximation of an expatriate's U.S. tax liability had he remained subject to residence basis taxation. It does not take into account, for example, consumption of the estate. Also, these examples do not take into account the very substantial—and for many, perhaps unquantifiable—benefits that inure to citizens and that are lost by expatriation. *See* Alice G. Abreu, *The Difference Between Expatriates and Mrs. Gregory—Citizenship Can Matter,* May 2, 1995, *available in* LEXIS, Fedtax Library, TNI File, 95 TNI 84-7. A citizen can renounce his citizenship by performing the acts listed in 8 U.S.C. § 1481 (1994).

96. It can safely be assumed that any built-in losses would be realized prior to expatriation.

There are basically three approaches to taxing expatriates. First, Congress could disregard changes of tax status and determine the tax consequences of a transaction or item of income by the status of the person at the time of receipt. This approach would give full weight to the realization principle. As discussed below,[97] the U.S. has adopted this approach for persons entering U.S. residence taxation, but for the last sixty years not for citizens leaving residence basis taxation. The weakness of this approach is that it would make residence basis taxation largely optional: For those persons who do not want to pay tax on accrued gains, or who wanted to change the taxation of their future U.S. source income, a change in tax status would be sufficient. In addition, this approach is inconsistent with the provisions discussed above that protect residence basis taxation.[98]

Second, Congress could continue to tax an expatriate's worldwide income. As discussed below,[99] this has been the general policy of the U.S. towards former citizens (and in limited circumstances resident aliens), except that the income base includes only *U.S. source* income for ten years following expatriation. This approach is flawed. It is inconsistent with the principle of economic neutrality as it encourages investment of foreign assets and non-income producing property, the gains from which are not subject to U.S. tax unless they are U.S. source and are realized. In addition, it raises issues of horizontal and vertical equity as similarly situated taxpayers may be taxed differently.

Third, Congress could mark-to-market property held by a person leaving or entering residence basis taxation, if a change in a person's tax status would change how the U.S. taxes his property. Consequently, for an expatriate, all property would be marked to market, and any accrued gain or loss would be realized. Since accrual taxation could cause hardships for taxpayers, especially with respect to illiquid or indirectly held property, e.g., trust interests, certain concessions could be made, for example, leaving property subject to U.S. residence taxation or deferring the income tax, albeit with an interest charge. In addition, it may be reasonable to exempt small gains. For a person becoming a U.S. citizen or resident, he would receive a fair market value basis for all of his property owned at the time he becomes subject to residence basis

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97. *See infra* text accompanying notes 243-295.
98. *See supra* text accompanying notes 67-90.
99. *See infra* text accompanying notes 137-194.

taxation. The same result would occur for property that begins to be used in a U.S. trade or business. A mark-to-market regime would ensure that only gains and losses accruing after the property is brought into U.S. tax jurisdiction would be subject to U.S. taxation, thereby eliminating the ambiguities and "trap for the unwary" features of current law.

Of the three choices, mark to market is superior as it best embodies the ability to pay and economic neutrality principles that undergird our income tax system. Congress has determined that U.S. citizens and residents should pay income tax on their worldwide income. Because of the realization principle,[100] however, gains accrued while a person was subject to residence basis taxation may escape taxation if the person expatriates and the gains are no longer taxed by the United States.[101] Some commentators have argued that the realization principle should be abandoned for all citizens and resident aliens,[102] because it causes

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100. Generally, gains and losses are taken into account only when they have been realized, the quintessential realization event being a sale or exchange of property for cash or other property. Upon the occurrence of a realization event, any gain or loss realized must be recognized, unless the Code specifically provides otherwise. I.R.C. § 1001(c) (West 1988 & Supp. 1996).

101. The modern view is that realization is a rule of administrative convenience; it would be burdensome for taxpayers to have to value their assets and for the Service to verify those valuations. *See* Cottage Savings Assoc. v. Commissioner of Internal Revenue, 499 U.S. 554, 565 (1991) (stating in dicta that the concept of realization is founded on administrative convenience, and citing *Horst*); Helvering v. Horst, 311 U.S. 112, 116 (1940); *see also* Murphy v. United States, 992 F.2d 929 (9th Cir. 1993) (upholding section 1256 mark-to-market regime, but on limited grounds of constructive receipt; constitutional issue not addressed); Garlock, Inc. v. Commissioner of Internal Revenue, 489 F.2d 197 (2d Cir. 1973) (upholding the controlled foreign corporation provisions) *cert. denied*, 417 U.S. 911 (1974); Eder v. Commissioner of Internal Revenue, 138 F.2d 27 (2d Cir. 1943) (upholding the foreign personal holding company provisions). Almost all commentators agree that realization is a rule of administrative convenience. *See, e.g.*, 1 BITTKER & LOKKEN, *supra* note 25, ¶ 5.2 at 5-20; Stanley S. Surrey, *The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions*, 35 ILL. L. REV. NW. 779 (1941); Joseph Dodge, *Further Thoughts on Realizing Gains and Losses at Death*, 47 VAND. L. REV. 1827 (1994). *But see* Henry Ordower, *Revisiting Realization: Accretion Taxation, The Constitution, Macomber, and Mark to Market*, 13 VA. TAX REV. 1 (1993) (arguing that *Macomber* remains valid and that realization remains a constitutional prerequisite for the taxation of gains from property). For a more dated view, see Edward T. Roehner & Sheila M. Roehner, *Realization: Administrative Convenience or Constitutional Requirement?*, 8 TAX L. REV. 173 (1953). Professor Ordower's conclusion is based on the fact that the Supreme Court has never explicitly overruled *Macomber.* It is nevertheless inconsistent and irreconcilable with Congress's views and actions over the last sixty years. *See, e.g.*, I.R.C. §§ 1291-1297 (PFIC provisions); §§ 551-558 (FPHC provisions); §§ 951-964 (CFC provisions); §§ 1271-1288 (original issue discount provisions); § 1256 (mark to market for section 1256 contracts); and § 475 (West 1988 & Supp. 1996) (marking to market property of securities dealers).

102. *See, e.g.*, Dodge, *supra* note 101; Mary Louise Fellows, *A Comprehensive Attack on Tax Deferral*, 88 MICH. L. REV. 722, 729 (1990); David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986);

economic efficiencies and inequities.[103] In limited cases, Congress has heeded these calls.[104] Even though there are strong arguments for abandoning the realization principle, especially with respect to easily valued and liquid assets, it is clear Congress is not moving to a full accrual tax system any time soon. In the case of persons changing tax status, however, there are strong reasons to abandon the realization principle.

A. *Mark-to-Market Taxation Would Reduce Economic Inefficiencies*

Adoption of an accrual taxation regime for persons and property moving into and out of U.S. residence or trade or business basis taxation would reduce the economic inefficiencies and inequities fostered by the current expatriate system.[105] The current rules applicable to persons and property entering and leaving U.S. tax jurisdiction cause economic inefficiencies by skewing the after-tax returns of investment of U.S. and

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David Slawson, *Taxing as Ordinary Income the Appreciation of Publicly Held Stock*, 76 YALE L.J. 623 (1967); Jeff Strnad, *Periodicity and Accretion Taxation: Norms and Implementation*, 99 YALE L.J. 1817 (1990); Note, *Realizing Appreciation Without Sale: Accrual Taxation of Capital Gains on Marketable Securities*, 34 STAN. L. REV. 857 (1982); City Bar Report, *supra* note 14.

103. Since accrued but unrealized gains are generally not taxed and new investments have to be made with after-tax dollars, taxpayers may have an incentive not to sell appreciated assets even though the new investment could generate a higher return. This lock-in effect causes taxpayers to forego higher yielding investments thereby leading to a less efficient allocation of capital and lower incomes for all. It also gives taxpayers an incentive to choose investments that yield no current income—growth stocks—over those that pay income currently—bonds and intangible property. Dodge, *supra* note 101, at 1837. The realization principle also creates inequities both between economically identically situated taxpayers (horizontal) and between wealthy taxpayers more of whose income consists of unrealized appreciation and less well-off taxpayers (vertical). *See id.* (stating that Haig-Simons rests on norm of ability to pay, which includes all the taxpayer's economic resources); Shakow, *supra* note 102, at 1115 (stating that "an accrual income tax system would be more equitable than current [realization based] system [because] [f]airness dictates that a tax system not tax more severely someone who sells an appreciated asset than someone who chooses to hold it.").

104. *See supra* note 101. The Treasury recently proposed treating hedging assets as a realization event. *See* Dep't of Treasury, News Release, Treasury Comments on "Short Against the Box" Proposal (Jan. 12, 1996). For a discussion of the problems raised by treating hedging as a realization event, see Deborah L. Paul, *Another Uneasy Compromise: The Treatment of Hedging in a Realization Income Tax*, 3 FLA. TAX REV. 1 No. 1 (1996).

105. Economic efficiency is understood to mean that the tax system should not favor one type of activity over another. Expressed another way, if two investments have the same pre-tax returns, they should have the same after-tax returns.

foreign investments and non-income producing property. For expatriates subject to the expatriate regime, there is an incentive to forego investments in U.S. assets in favor of investments in foreign property; once the person is no longer subject to residence basis taxation, foreign source income and gains are no longer subject to U.S. tax. For expatriates not subject to the expatriate regime, there is somewhat less of an incentive to forego investments in U.S. property. Once an expatriate is taxed on a source basis, the United States does not tax gains from the sale of personal property. (Gains with respect to U.S. real property, however, would be taxed.) With respect to the deployment of capital to be used in a trade or business, however, an incentive still exists to invest in foreign property because, upon expatriation, the return on those assets in the form of income or gain will no longer be subject to U.S. tax. Furthermore, for persons contemplating temporary U.S. residency, there is also an incentive to invest in foreign assets, especially non-income producing assets, provided that the assets will not be sold or exchanged during U.S. residency. A mark-to-market regime would eliminate all of these economic inefficiencies by ensuring that the gain from any asset—whether foreign or U.S.—that accrues during the period a person is subject to U.S. residence basis taxation would be subject to U.S. tax.

B. Mark-to-Market Taxation Would Reduce the Inequities of the Current System

A mark-to-market regime for persons and property leaving and entering U.S. tax jurisdiction would also better embody tax fairness, which traditionally consists of two concepts, horizontal equity and vertical equity. Horizontal equity requires that persons who are similarly situated (have the same economic income) should be treated equally (pay the same amount of taxes). Vertical equity requires that persons with greater incomes should pay more taxes than persons with lesser incomes.

To apply these norms, it is first necessary to determine whether two taxpayers are similarly situated. Assume that two persons expatriate, and one owns appreciated stock of a foreign company and the other appreciated stock of a U.S. company. Under the U.S. expatriate regime discussed below, an expatriate who owns appreciated stock of a foreign company and sells it the day after expatriation will escape U.S. tax. In contrast, an expatriate holding equally appreciated stock of a U.S. corporation who sells the day before expatriation will be subject to U.S. tax. These two persons, although identically situated, will have different U.S. tax burdens, thereby violating the norm of horizontal equity. Furthermore, if the stock of the U.S. corporation has appreciated less than the stock of the foreign corporation, taxing the sale of the former but not the latter violates the norm of vertical equity. In addition, the current system can be a trap for the unwary: If the person holding the stock of the foreign corporation sells it prior to expatriation, she is taxed, but if she sells it after, she is not taxed. Marking to market the property of all persons leaving or entering U.S. residence or trade or business basis taxation ensures that all income that accrued during U.S. tax residency, whether or not realized and wherever the property is located, would be subject to tax, and a fortiori would improve horizontal and vertical equity.

It may be argued that the relevant comparison should be an expatriate and a citizen or resident who does not expatriate, and consequently, horizontal equity may be violated because the expatriate will have to pay tax earlier on appreciated property than will the citizen or resident. Also, the citizen or resident may never have to pay income tax on the accrued gains if he dies holding the property, because under section 1014, his heirs will take a fair market value basis for the property as of the date of death.[106] These arguments are not convincing. A citizen is not similarly situated with an expatriate because, upon expatriation, the expatriate is subject to U.S. tax only on a source or trade or business basis. The tax base is much narrower for expatriates than for citizens and residents. In addition, although section 1014 operates to eliminate accrued gains at death, because there is no sound policy rationale for section 1014,[107] the United States should not let section 1014 determine its approach to taxing expatriates. Under my approach, an expatriate could get the benefit of section 1014 if the property remained subject to U.S. tax.

C. *Mark-to-Market Taxation is Consistent With Other Code Provisions*

For persons leaving U.S. tax jurisdiction, accrual basis taxation protects residence basis taxation under principles similar to those embodied in other Code provisions intended to protect residence basis taxation. These provisions protect residence basis taxation by not permitting the tax-free transfer of property outside of U.S. residence basis taxation. Similarly, once a person is no longer subject to residence

106. I.R.C. § 1014 (West 1988).
107. Dodge, *supra* note 101.

basis taxation, the U.S. may lose the right to tax any income or gain from assets held by the taxpayer. A change in tax status is, therefore, an appropriate moment to realize gain or loss. For property that becomes subject to U.S. tax, accrual taxation is conceptually consistent with sections 864(c)(6) and (7), discussed below,[108] which tie the taxation of income or gain of nonresidents not to their status when income is received but when it was economically earned.

D. Mark-to-Market Taxation for Persons or Property Entering U.S. Residence or Trade or Business Basis Taxation Would Improve the Fairness of the Current System

For persons or property becoming subject to U.S. residence (or trade or business) basis taxation, an accrual regime would eliminate any pre-residency (or pre-U.S. trade or business) built-in gain or loss. As discussed below, under the current system, to determine gain or loss, a taxpayer must recreate the U.S. tax history of property that becomes subject to U.S. taxation, a potentially insoluble task. Because pre-residency appreciation can be eliminated merely by reselling and purchasing the property, the current system is a trap for the unwary or for those persons who hold illiquid property. Prior to a person or property entering U.S. tax jurisdiction, the income earned by that person or gain or loss recognized with respect to the person's property is generally of no consequence for U.S. tax purposes; unrealized gain or loss accruing prior to U.S. tax residency should likewise be disregarded.

E. Mark-to-Market Taxation May Be Easier to Administer Than the Current Expatriate System

As discussed below,[109] under the current expatriate regime, the United States must monitor an expatriate's dealings in property for ten years following expatriation. With the recent expansion of the coverage of the expatriate provisions, more administrative resources will be necessary to monitor an expatriate's dealings in property. Because in many cases, the property and the expatriate will not be located in the United States, this will not be an easy task.

A mark-to-market regime may be easier to administer. Although a mark-to-market regime would create some additional administrative burdens because immigrants and expatriates would have to value their property, instead of relying on third-party transactions, these burdens

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108. *See infra* text accompanying notes 214-222.
109. *See infra* text accompanying notes 137-194.

would be tolerable. Except in the case of illiquid property, valuations would be easy to obtain. To reduce administrative costs, a de minimis exception could be crafted to eliminate the need to value consumer durables and similar items. Also, valuations would be required only once in the case of a citizen who expatriates, as currently occurs for U.S. transfer tax purposes. For immigrants who later expatriate, they would have to value their property only twice.

IV. ISSUES RAISED BY A MARK-TO-MARKET REGIME

A mark-to-market regime applying to persons entering and leaving U.S. residence basis taxation would raise significant tax policy issues. These issues include: the scope of the provision (who should be subject to accrual taxation); what provisions should be made for persons holding illiquid or hard to value assets; what account should be made for assets indirectly held, for example, by a partnership or trust; what account should be made for foreign income taxes; should the provision override existing treaties; and how would accrual basis income taxation mesh with our wealth transfer tax system. This section will discuss possible approaches to these issues. Differences and similarities with the proposed (and rejected) mark-to-market legislation ("proposed legislation") will be noted.[110]

A. Who Should Be Subject to Mark-to-Market Taxation

From the standpoint of fairness—similarly situated persons should be taxed similarly—all persons (or property) leaving or entering U.S. residence (or trade or business) basis taxation should be subject to accrual taxation.[111] It must be recognized, however, that such a regime

110. The mark-to-market expatriate proposed legislation was significantly modified during the course of the legislative debate. Unless otherwise noted, in examining the approach of the rejected mark-to-market legislation, I will refer to the proposed expatriate provisions that were approved on June 12, 1996 by the Senate Finance Committee as part of *The Small Business Job Protection Act of 1996*, H.R. 3448, 104th Cong. §§1631-1633 (1996).

111. The proposed legislation does not permit a mark-to-market adjustment for property brought into U.S. tax jurisdiction, although some earlier versions of the expatriate proposals permitted resident aliens (but not citizens) subject to accrual taxation to step up the basis of property held upon becoming subject to residence basis taxation to its fair market value. S. 700, 104th Cong. § 1 (1995) (proposing change to I.R.C. § 1061) [hereinafter Proposed I.R.C. § 1061].

could cause tax administration problems, especially in the case of resident aliens, who can become nonresidents merely by departing from the United States. Therefore, a de minimis rule exempting persons with small incomes may be appropriate. Recognizing that the aim of accrual taxation is to protect residence basis taxation, which is tied to the ability-to-pay principle, any de minimis rule should be based solely on the expatriate's income,[112] and not length or type of residency.[113] The mark-to-market regime should apply each time a person changes U.S. tax status.[114]

B. *What Property Should Be Marked to Market*

1. *General*

Upon expatriation, all property interests of an expatriate should be marked to market, unless the property continues to be subject to residence or trade or business taxation. Upon immigration, all property should be marked to market, unless the property is already subject to net

112. Under the proposed legislation, the first $600,000 of net gains are excluded from income. H.R. 3448, 104th Cong. § 1631 [hereinafter Proposed I.R.C. § 877A]. Although the $600,000 is clearly drawn from the exemption amount under the estate and gift tax, because the two taxes are conceptually different, there is no tax policy reason for using the same amount.

113. Under the proposed legislation, only "covered" expatriates, which includes former citizens and "long-term" residents, are subject to the mark-to-market regime. Proposed I.R.C. § 877A(a)(1). The scope of the proposed legislation is therefore substantially coterminous with that of the current expatriate regime. As discussed below, there seems to be no plausible tax policy reason to subject only green card holders to accrual basis taxation. The proposed legislation also provides to two narrow exceptions. A person will not be treated as a covered expatriate if she is from birth a dual citizen of the U.S. and another country, at the time of expatriation is still a citizen of and taxed as a resident of the other country, and has not satisfied the substantial presence test for more than eight of the last fifteen years. Proposed I.R.C. § 877A(c)(2)(A)(i)-(ii). Also excluded are persons renouncing their citizenship prior to attaining age eighteen and one-half, provided that they have not satisfied the substantial presence test for not more than five taxable years before expatriation. Proposed I.R.C. § 877A(c)(2)(B)(i)-(ii). The rationale for these exclusions is inconsistent with accrual taxation.

114. Under the proposed legislation, a person would not be subject to the mark-to-market regime more than one time in a fifteen year period. Proposed I.R.C. § 877A(e)(4)(B). The rationale for this rule is unclear. Because any of the resident's property would be marked to market and would therefore receive a fair market value basis, there is no possibility of subsequent double U.S. taxation. Provided that when the person became a resident alien again, her property was marked to market, upon a subsequent departure from residence basis jurisdiction, only gain that accrued during such time would be taxed. It is therefore inconsistent with the underlying policy of accrual taxation to exempt a person merely because she has been subject before to it.

basis taxation.[115] For example, if a foreign person owns U.S. real estate, it should not be marked to market if the owner became subject to U.S. residence taxation.

Any gains that are realized should be recognized, and any losses that would be recognized upon an actual sale of the property should be allowable. Nonrecognition provisions should not apply, because their function is to defer the recognition of gain, not to exclude it permanently. Gains that would otherwise be permanently excluded, however, should also be excluded under a mark-to-market regime. Deferral of the tax could be permitted, albeit with an interest change to compensate the government for the time value of money.

The proposed legislation is generally consistent with this proposal. Excepted from accrual taxation are U.S. real property interests ("USRPIs"), certain retirement plans, and certain trust interests.[116] In

115. S. 700, 104th Cong. § 1 (1995) (proposing change to I.R.C. § 1061), which marks to market property brought into U.S. tax jurisdiction, raises several issues. It was unclear how to treat property whose basis is determined by reference to property brought into U.S. residence basis taxation. Property acquired after the owner becomes a resident or citizen and whose basis is determined with reference to the basis of the property held on such date should also be stepped up. Likewise, if a person transfers property whose basis is stepped up under proposed section 1061, and the transferee's basis in the property is determined by the transferor's basis, the stepped up basis should carry over in the hands of the transferee. NYSBA, *Report on Proposed Legislation on Expatriation and Foreign Trusts*, at 7, Jun. 19, 1995, *available in* LEXIS, Fedtax Library, TNT File, 95 TNT 118-6 [hereinafter NYSBA Report]. In the absence of such a rule, the elimination of preresidency gain or loss would be only temporary—until the property was sold—and not permanent. A contrary rule could easily be avoided by having the new resident or citizen first sell the property, immediately repurchase it, and then transfer it to another person or entity.

116. Proposed I.R.C. § 877A(d)(1)(A)-(B). Any gains realized on the deemed sales must be recognized, regardless of any nonrecognition provision, unless the gain is excluded under sections 101 to 137. The most significant exception is the exclusion for gain from the sale of a principal residence for a person fifty-five years or older under section 121. Losses are taken into account to the extent permitted under section 165, except that the wash sale rules of section 1091 do not apply, but the straddle rules of section 1092 apply. It is unclear why section 1092 applies. I.R.C. § 1092 (West 1988 & Supp. 1996) generally prevents taxpayers from recognizing losses to the extent that there is unrecognized gain in an offsetting position. Thus, assume that a taxpayer buys stock and purchases a put option on the same stock; any rise in the value of one position will be offset in a fall in the value of the other position. If the loss position is sold, section 1092 generally prevents recognition of the loss until the gain position has been recognized. Since generally all property is deemed sold upon expatriation and all gain must be recognized, there is no unrecognized gain at the time of expatriation, and, accordingly, the straddle rules should not apply. One possible application of section 1092 would be when there is unrecognized gain because the property is excluded from

theory it is appropriate to exclude these interests in property, because they will be taxed by the U.S. even though the owner is not subject to residence basis taxation. The exclusion for all USRPIs may be too broad.[117] Stock of a corporation will be a USRPI if the fair market value of its U.S. real property interests equal or exceed the value of trade or business assets or its foreign real property interests. Because stocks and securities are not considered to be trade or business assets, a U.S. corporation whose assets consist of a hovel in Appalachia and $100 million of appreciated stock will be a USRPI. A sale of the hut will rid the U.S. company of USRPI status, and the stock can subsequently be sold tax free.

2. *Illiquid Property and the Deferral of Income Tax*

One traditional argument raised in opposition to accrual taxation is that taxpayers would be forced to liquidate their assets in order to pay the income tax. If no provision were made for illiquid property, a person contemplating expatriation, especially if her property were indirectly held, for example, in a trust, may be precluded from exercising her right to expatriate. Therefore, it makes sense to include some provision for dealing with illiquid property. There are two possible approaches.[118] One would be to call off accrual taxation with respect

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mark-to-market taxation.

Under proposed Proposed 877A(d)(2)(B)(i)-(ii), interests in a qualified retirement plan, and under Treasury regulations, interests in foreign pension plans or similar retirement arrangements, are not marked to market. A qualified retirement plan is defined by reference to section 4974(c), which includes a plan described in section 401(a), an annuity plan or contract described in section 403(b), an individual retirement account or annuity described in section 408(a) or (b), or other plan, contracts, or annuities designed by the Service. I.R.C. § 4979(c)(1)-(5) (West 1989). For qualified retirement plans, any interest attributable to contributions exceeding any limitation or violating any condition for tax-favored treatment is subject to mark-to-market treatment. This provision limits the possibility of avoiding the expatriate provisions by contributing excessive amounts property to a qualified retirement plan or establishing a nonqualified retirement plan and contributing property to the plan. Furthermore, for foreign pension plans, only up to $500,000 may excluded. This limitation may be easily exceeded for highly compensated executives.

117. A U.S. real property interest includes both direct interests in U.S. real property as well as any interest in a U.S. corporation that was a U.S. real property holding company at any time during the five years before disposition of such interest. I.R.C. § 897(c)(1)(A)(i)-(ii) (West 1988 & Supp. 1996).

118. Under the proposed legislation, expatriates have two options to defer current taxation. First, a covered expatriate may elect to remain subject to U.S. residence basis income and wealth transfer taxation with respect to *all* property held at the time of expatriation or to property whose basis is determined in whole or in part by reference to property held at expatriation. Proposed I.R.C. §§ 877A(a)(4)(A), (D). Prior proposed versions of the expatriate provisions permitted an expatriate to make an asset-by-asset

to property that remains subject to U.S. net taxation. The other would be to impose an interest charge on any deferred gain.

If accrual taxation is called off with respect to some or all of an expatriate's property, the hybrid status of an expatriate in such cases will raise additional issues. For instance, will it be possible to transfer property with built-in losses into U.S. tax jurisdiction to offset the built-in gains at the time of expatriation? One possible approach to this problem is that of the regulations under section 897. These regulations limit the extent to which built-in losses of property that is not U.S. real property can be used to offset any gain recognized from the sale or exchange of a U.S. real property interest.[119] (Of course, this problem would not exist if property were marked to market when it becomes subject to U.S. tax.)

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election. It is unclear why this option was later deleted. In addition, under the proposed legislation, because USRPIs are not subject to the mark-to-market regime, an expatriate can transfer any property that she wants to remain subject to residence basis to a USRPI. Thus, mark-to-market taxation is called off, but if the property is subsequently disposed of in a taxable transaction, any gain will be taxed, and if the property is transferred by gift or bequest, U.S. gift and estate tax will apply.

In addition to the election to continue to be taxed as a U.S. citizen on all property subject to the expatriate regime, the proposed legislation permits a covered expatriate to make a property by property election to defer tax, albeit with an interest charge and the posting of security. For property subject to the election, in the year in which property is disposed of, the expatriate's tax for the year of sale is increased by the "deferred tax amount." Proposed I.R.C. § 877A(b)(1). The proposed legislation also provides that unless otherwise provided in the regulations, dispositions included non-recognition transfers. *Id.* The deferred tax amount is the difference between the tax paid in the year of expatriation and the tax that would have been paid if the deferral election had not been made, increased by an interest charge. Proposed I.R.C. § 877A(b)(2)(A). Losses that are recognized upon expatriation are allocated ratably among the gains recognized. Proposed I.R.C. § 877A(b)(2)(B).

Proposed § 877A(b)(3)(B) provides that security is adequate "if it is a bond in an amount equal to the deferred tax amount" or an amount otherwise established as adequate under regulations. One commentator has criticized the security requirement, especially how it applies to indirectly held property. For example, if the property for which an election has been made to defer tax is a trust interest but that is quite large because it is nonvested interest that is never distributed to the beneficiary, the bond amount could be so large as to make posting it financial impossible. NYSBA Report, *supra* note 34, at 61. As the drafters of the report note, the posting of security should not be a principal concern because enforcement of the expatriate provisions will in large measure depend upon voluntary compliance. *Id.* Post-expatriation gain escapes U.S. tax, but built-in gain at the time of expatriation is not reduced by post-expatriation loss. This election is therefore only advantageous to the extent the post-expatriation gain in the property is anticipated to exceed the rate of interest charged (plus security costs).

119. Treas. Reg. § 1.897-6T(c) (1996).

Another significant issue that could arise is how to treat the debt proceeds secured by such property, especially nonrecourse debt. For example, if an expatriate owns property with a basis of one million dollars and a fair market value of ten million dollars for which an election under proposed section 877A(a)(4) has been made and borrows ten million dollars secured only by the property, at death, his U.S. taxable estate will be zero, assuming that the ten million dollars has not been invested in U.S. situs property. Furthermore, no income tax will be due when the creditor forecloses on the property because the property will have a stepped-up basis in the hands of the estate. This result would not occur for U.S. citizens and residents because the ten million dollars received as loan proceeds (or property purchased with the ten million dollars) would be includable in the decedent's gross estate. There is no easy solution to this problem. Some possible solutions would be to limit the extent to which one could mortgage property covered by the election for some period prior to or after expatriation, to require the loan proceeds or property purchased with the loan proceeds to be also subject to U.S. residence basis taxation, or to make borrowing in excess of the property's adjusted basis a realization event.

3. *Inside/Outside Basis Issues*

Assets held by look-through entities, such as partnerships and trusts, raise additional issues. The policy issue is whether to adopt an entity or aggregate approach.[120] Assume that upon becoming a U.S. resident, a foreigner is a 50-50 partner (all gains, losses, etc, are allocated 50-50) in a foreign partnership that holds foreign property with an adjusted basis of $500 (fair market value of $1000) and the partner's basis in her partnership interest is $250 (fair market value of $500). Under an entity approach, the partner is deemed to hold an interest solely in the entity and not in the entity's assets. Accordingly, in the example, only the partner's interest in the partnership would be marked to market. A sale by the partnership of the asset for $1000 would produce $500 of gain, and each partner would be taxed on $250, even though the appreciation occurred prior to the partner becoming a U.S. resident. Conversely,

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120. The taxation of partnerships and trusts presents aspects of both approaches, and although the Service has argued more recently for aggregate approach for partnerships in the international area, it has not been entirely successful in convincing courts of the rectitude of its position. *See* Brown Group v. Commissioner of Internal Revenue, 77 F.3d 217 (1996). *Compare* I.R.C. § 741 (West 1988) (sale or exchange of partnership interest is sale of capital asset irrespective of property held by partnership) *with* I.R.C. § 702 (West 1988 & Supp. 1996) (each partner takes into account distributive share of partnership tax items); *see also* Rev. Rul. 91-32, 1991-1 C.B. 107.

under an aggregate approach, the partner or beneficiary is treated as owning a proportionate share of the entity's assets. Accordingly, since both the partner's interest in the partnership and the partnership's assets would be marked to market, upon a sale of the asset for $500, no gain or loss would be realized. The second approach is preferable because a partner could, immediately prior to becoming a U.S. resident, cause a distribution of partnership assets, sell and repurchase the property to step up its basis, and recontribute it to the partnership. Adopting an entity approach would be a tax only on the poorly advised or a partner who could not cause a distribution of partnership property prior to becoming a citizen or resident.[121]

The step up in basis of assets held by a conduit entity such as a partnership or trust should apply only to assets the sale of which would not produce gain subject to U.S. income tax prior to the direct or indirect owner becoming a U.S. resident. A contrary rule would permit a nonresident alien to avoid U.S. income tax on appreciated property subject to U.S. tax merely by becoming a resident alien.[122]

4. *Interests in Trusts*

If a person expatriates and is a beneficiary of a trust, complex issues arise as to the proper treatment of trust interests and property held by trusts. The source of this complexity is that an individual can be a beneficiary of a trust that she may or may not have established, having no control over the timing or amount of distributions from the trust, which can be made entirely at the discretion of a third-party trustee. In addition, the trust could be either a U.S. or foreign trust, which is subject to special rules.[123] For example, a grandparent could establish a trust

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121. The same rule should apply to property held by trusts. *See* NYSBA Report, *supra* note 115, at 7. Proposed § 1061(d), *supra* note 111, grants the Service authority to prescribe regulations in the case of property which consists of a direct or indirect interest in a trust.

122. Under proposed § 1061(b), *supra* note 111, if a person becomes a resident alien, gain or loss is determined using the fair market value as of the *earliest* date the property becomes subject to U.S. tax, because the owner becomes a resident alien or the property is used in a trade or business or is a U.S. real property interest.

123. The approach to taxing trust beneficiaries under an accrual regime changed considerably during the expatriate debate. The difficulty was how to formulate a coherent policy that protected the fisc but that was also technically consistent with the U.S. income and transfer regime applicable to trusts and their beneficiaries. For detailed technical discussions of prior versions of the proposed legislation addressing trust issues,

for all of her grandchildren and under the terms of the trust agreement, the trustee could have the power to distribute income and corpus among the beneficiaries at the trustee's sole discretion. In such cases, it is virtually impossible to determine the value of the beneficiary's interest in the trust. In the case of a beneficiary with a life interest or term interest in trust property, however, it would be possible to value the interest. Some account must be taken of property held by discretionary beneficiaries; otherwise, it would be simple for a person contemplating expatriation to avoid accrual taxation by merely transferring property to a trust the terms of which grant the fiduciary the power to distribute income and corpus at her discretion.

The simplest approach in the case of trusts would be to impose a tax at the time of distribution from the trust to the expatriate beneficiary to the extent that the distribution is attributable to pre-expatriation gain. For this withholding mechanism to work, however, the trust, the trust property, or the trust fiduciary would have to be subject to U.S. jurisdiction to ensure that the tax could be collected. Thus, in the case of foreign trusts with foreign situs property and foreign trustees, the withholding mechanism would not be administrable. In addition, it may be necessary to impose some type of interest charge on the distribution in order to prevent avoidance of accrual taxation. For example, assume that a person contemplating expatriation transfers appreciated property to an irrevocable, discretionary non-grantor trust. If the trust interest were not marked to market, the trust could hold the property, sell it at a later date, and distribute the proceeds to the expatriate. The beneficiary would be in a better position than if he had held the property directly.[124] This approach could cause hardship: If the trust property

see Testimony of Carlyn S. McCaffrey at Ways and Means Oversight Subcommittee Hearing on Expatriate Tax, Mar. 27, 1995, *available in* LEXIS, Fedtax Library, TNT File, 95 TNT 60-26 (Mar. 28, 1995); NYSBA, *Memorandum to the Members of the House Ways and Means Subcommittee on Oversight,* Mar. 30, 1995, *available in* LEXIS, Fedtax Library, TNT File, 95 TNT 62-45; NYSBA Report, *supra* note 115, at 15-21.

124. Under the proposed legislation, the treatment of expatriates who are trust beneficiaries at the time of expatriation depends on whether the interest is an interest in a "qualified" or "non-qualified" trust. A qualified trust includes any trust organized under and governed by U.S. law or the law of a state, and which the trust instrument requires that at least one trustee be an individual citizen of the U.S. or a domestic corporation. A qualified trust would include qualified domestic trusts under section 2056A, but would not include foreign trusts, which would be covered instead by the rules applicable to nonqualified trusts. If an expatriate holds an interest in a qualified trust, the interest is not marked to market, but instead, taxes are imposed on distributions from the trust to the expatriate. The purpose of this regime is to subject to tax the built-in gain in the trust property at the time of expatriation, but only when either the trust property or the proceeds from the sale of trust property are distributed.

declines in value from the date of expatriation until the property (or proceeds from its sale) is distributed, the tax imposed on the distribution could be confiscatory.[125]

For interests in foreign trusts, the approach of the proposed legislation, which would determine an expatriate beneficiary's interest "based upon all relevant facts and circumstances," is probably the best solution.[126]

Specifically, the tax imposed on trust distributions is the lesser of two amounts. The first amount is the highest rate applicable to trusts in the year of expatriation. Proposed I.R.C. § 877A(f)(2)(B)(i). The second is the balance in the "deferred tax account," which consists of the built-in gain in the trust's assets at the time of expatriation allocable to the expatriate's interest, decreased by taxes previously paid on trust distributions under proposed I.R.C. § 877A(f)(2)(A), and increased by an interest charge on the balance of the deferred tax account. The opening balance of the deferred tax account is the tax that would have been imposed on the "allocable expatriation gain" if the trust interest had been marked to market on the date of expatriation. Proposed I.R.C. § 877A(f)(2)(C)(i). The "allocable expatriation gain" is the gain allocable to the expatriate's "vested and nonvested" interests in the trust "if the beneficiary held directly all assets allocable to such interests." Proposed I.R.C. § 877A(f)(2)(D). A vested interest is any interest that is vested in the beneficiary, such as, for example, a non-contingent or non-discretionary interest, and a non-vested interest an interest that is not vested and is determined by "assuming the maximum exercise of discretion in favor of the beneficiary and the occurrence of all contingencies in favor of the beneficiary." Proposed I.R.C. § 877A(f)(2)(G)(ii)-(iii). The opening balance in the deferred tax account is decreased by taxes previously paid on such distributions. Proposed I.R.C. § 877A(f)(2)(C)(iii)(I). The Service is granted authority to draft regulations that would decrease the deferred tax account for persons holding nonvested interests for taxes paid on distributions from the trust with respect to nonvested interests not held by such person.

For example, assume that a trustee of a trust holding one share of two corporations, each with an adjusted basis of $500 and a fair market value of $1000, can allocate income or distribute corpus at its discretion to two beneficiaries, one of whom expatriates. Assume that the highest trust tax rate is 40%. Under proposed section 877A(f)(2)(D), the allocable expatriation gain would be $400, because it would represent the tax on the gain allocable to the beneficiary's vested and nonvested interests under proposed section 877A(f)(2)(G)(iii)—$1000. Disregarding interest, upon a sale of one share of stock for $1000 and a distribution of that amount, the distribution would be subject to tax of $400 and the deferred tax account would be reduced to zero, with the consequence that further distributions from the trust would not be taxed.

125. Assume the same facts as above except that the fair market value of both shares of stock declines to $250, at such time the stock is sold and the proceeds—$500—are distributed to the expatriate. The tax imposed on the distribution would be $200 ($500 x 40%), even though no gain was recognized by the trust. This result is consistent with the result that would have occurred had the expatriate elected to defer the tax.

126. Under proposed I.R.C. § 877A(f)(3), the Service would take into account the terms of the trust instrument and any letter of wishes or similar document, historical patterns of trust distributions, and the existence of functions performed by a trust

Also, some consideration may be given to treating foreign trusts established by a person who expatriates differently than trusts established by third parties.

5. *Gratuitous Transfers of Property Into and Out of U.S. Residence Basis Taxation*

One issue that accrual taxation raises is whether to tax accrued gain on property that is gifted to persons outside of residence basis taxation, *e.g.*, a nonresident alien.[127] (Or whether to mark to market property gifted into U.S. residence basis tax jurisdiction.) For gifts to U.S. persons, the accrued gain is preserved by section 1015.[128] For gifts to foreign persons, unless the gifted property continues to be subject to U.S. taxation, either because it is used in U.S. trade or business or a U.S. real property interest, the accrued gain may forever escape U.S. tax. For property gifted into U.S. residence basis taxation, any accrued gain can be eliminated by merely selling the property and gifting the proceeds.

To answer this question, it is necessary first to determine whom to compare in deciding whether horizontal equity is violated by not marking to market such gifts. If the appropriate comparison is between a gift made between both persons subject to residence basis taxation and a gift made between one person subject to residence basis taxation to another who is not, then horizontal equity is violated by not taxing the accrued gain at the time of the gift. Section 1015 defers taxes, but if such gain is not taxed upon a subsequent sale, then section 1015 operates as a forgiveness mechanism.[129] On the other hand, if the appropriate comparison is between persons transferring property at death and persons making inter vivos transfers, because section 1014 eliminates built-in gain at death, it may not be appropriate to tax gifts.[130] One response to such argument is that gifts are planned whereas death is not generally planned. On the other hand, many realization events are also unplanned, e.g., involuntary conversions.

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protector or any similar advisor. Once an expatriate's interest in a nonqualified trust has been determined, it is treated as a separate trust, which is marked to market and then deemed recontributed back to the trust. This treatment raises myriad issues that would require complex regulations to sort out. *See* NYSBA Report, *supra* note 115, at 19-21. One commentator has suggested this standard is too vague and could lead to "substantial inequities" in its application. *Id.* at 19.

127. This is the approach under the proposed PFIC regulations.

128. I.R.C. § 1015 (West 1988).

129. *Id.*

130. Under the proposed PFIC regulations, death in some cases would be treated as a taxable event.

Also, if the purpose of section 1014 is to relieve heirs from having to recreate the tax history of inherited property, in the case of gifts the donor would generally be able to obtain the necessary information, and there would be no administrative burden.

6. *Interaction of Accrual Taxation and U.S. Wealth Transfer Taxes*

If an expatriate is subject to accrual taxation at the moment of expatriation, for example, with respect to stock of a U.S. company, the same property could also be subject to U.S. transfer tax. If, however, the person had not expatriated, the stock would be subject only to U.S. estate tax, because under section 1014, any accrued gain would be eliminated.[131] When Canada and Australia adopted a mark-to-market regime for immigrants, expatriates, and property passing by gift or death, they simultaneously abolished their wealth transfer and death tax systems.[132] Since abolishing the U.S. wealth transfer system is probably not likely in the near future, what accommodation, if any, should be made for future wealth transfer taxes?

There is generally little accommodation between income and transfer taxes.[133] This is because the two taxes are conceptually distinct: Income taxes are only imposed once on income, and through the mechanism of basis are not imposed again on the same amount. Transfer taxes, in contrast, are imposed on amounts that may have already been subject to income tax. Thus, upon a sale of appreciated property and a transfer of the proceeds, a taxpayer could be subject to income, gift, estate, and generation skipping taxes. Any income tax paid, however, would reduce the amount of the taxpayer's estate, in essence, making the income tax deductible. Consequently, for property

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131. I.R.C. § 1014 (West 1988).

132. *See* Richard M. Bird, *Canada's Vanishing Death Taxes*, 16 OSGOODE HALL L.J. 133, 137 (1970).

133. Two exceptions are section 1015(b), which allows a donee to step up the basis of property transferred by the amount of gift tax paid that is attributable to the built-in gain, and section 691(c), which permits a deduction for estate tax paid with respect to income in respect of decedents. Both of these provisions reflect administrative concerns rather than sound tax policy. For a discussion, see BITTKER & LOKKEN, *supra* note 25, ¶ 41.3.2. at 41-24 to 41-26, ¶83.1.4. at 83-11 to 83-12.

subject to accrual taxation and U.S. transfer taxes, the income taxes paid should be allowed as a deduction against future U.S. transfer taxes.[134]

V. EXPATRIATE INCOME AND WEALTH TRANSFER TAX REGIMES

This part discusses the U.S. expatriate income and wealth transfer tax provisions, which were originally enacted in 1966 in the Foreign Investors Tax Act ("FITA") and recently amended in the Health Insurance Portability and Accountability Act of 1996.[135] The general

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134. Under proposed section 877A(i), if property is marked to market upon expatriation, and the property is includable in an expatriate's U.S. estate solely because of section 2107 or subject to U.S. gift tax solely because of section 2501(a)(3), the income tax paid upon expatriation will be allowed as a credit against the gift or estate tax. The policy behind this provision appears to be that the expatriate income tax is a prepayment of U.S. wealth transfer tax. *See* NYSBA Report, *supra* note 115, at 15 (stating that "one of the purposes of the expatriation tax is to compensate the U.S. for the future estate taxes it will lose as a result of the expatriation."). This is a weak rationale. If the expatriate's property has not appreciated, there may be little or no income tax payable, even though the property could be worth $1 billion.

If the income and transfer tax are treated as a single tax, perhaps on the grounds that had the expatriate remained a citizen and held the property until death, no income tax would be due because of section 1014, it is unclear why the credit is limited to property included in the expatriate's gross estate or subject to gift tax solely under sections 2501(a)(3) and 2107. If the rationale is that the expatriate tax is prepayment of transfer tax, it should arguably be available against any gift and estate tax subsequently paid with respect to any property that has been marked to market and is subject to U.S. wealth transfer tax. *See* NYSBA Report, *supra* note 115, at 13. More importantly, a credit may be too generous. Assume that a U.S. citizen expatriates while holding 100% of the stock of a foreign corporation (adjusted basis of $500 and fair market value of $1000) the sole asset of which is stock of a domestic corporation (adjusted basis of $500 and a fair market value of $1000). Upon expatriation, the expatriate pays $200 of income tax (40% times $500 gain), which he obtains by borrowing on a nonrecourse basis against the stock. At death, the expatriate's estate tax liability will be $240 (55% of $800 less a credit of $200), for a total U.S. tax of $440. Had the expatriate remained a citizen, however, his total U.S. tax liability would have been $550 ($1000 times 55%) had he held the stock until death, and $640 [($500 gain times 40%) plus ($800 ($1000 proceeds less $200 in income taxes) times 55%)] had he sold the stock and held on to the proceeds until death. If instead of a credit, however, a deduction were permitted for the U.S. income tax paid, the total tax paid would be $530 [($200 ($500 gain times 40%) plus 55%) times ($800 less $200 income taxes paid)].

135. I.R.C. § 877 (West 1988 & Supp. 1996) (income tax); I.R.C. § 2107 (West 1988 & Supp. 1996) (estate tax); I.R.C. § 2501(a)(3) (West 1988 & Supp. 1996) (gift tax). Congress has been concerned with expatriation since 1937. In 1936, Congress enacted a bifurcated tax regime for nonresidents that was similar to the current tax regime applicable to nonresidents. Congress became concerned that U.S. citizens would expatriate to take advantage of the lower rate—10%—applicable to FDAP income of nonresidents. One year later, Congress amended the revenue law by imposing net basis taxation on all nonresidents with FDAP income in excess of $21,600. Revenue Act of 1937, Pub. L. No. 377 § 501,50 Stat. 813. This amount reflected the amount at which the effective tax rate for U.S. persons was 10%. *See* WAYS AND MEANS COMMITTEE REPORT NO. 1546, 75th Cong. at 23 (1937); REPORT OF THE JOINT COMMITTEE ON TAX EVASION AND AVOIDANCE, H.R. DOC. NO. 337, at 23 (1937). This reaction could be

policy underlying the expatriate tax provisions is to equalize the U.S. tax burdens of expatriates with their U.S. tax liabilities had they not expatriated. To accomplish this, the income and transfers of property of expatriates are subject to U.S. tax on the same basis as citizens and residents for ten years following expatriation, but only with respect to U.S. source income and transfers of U.S. situs property. This approach, however, is flawed.

A. Income Tax Provisions

1. Persons Subject to the Expatriate Income Tax Provisions

To deter persons subject to residence basis taxation from renouncing their citizenship or abandoning their U.S. residency to avoid U.S. income tax, section 877(a) subjects tax-motivated expatriates to U.S. income tax at graduated rates on their U.S. source income for ten years following expatriation.[136] An expatriate whose average annual net income tax exceeded $100,000 for the five taxable years expatriation, or whose net

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described as throwing out the baby with the bathwater.

136. I.R.C. § 877(a)-(b). More technically, once the necessary showing of tax-avoidance purposes is made, then for a 10-year period following expatriation, the expatriate is taxed as follows. First, the expatriate's tax liability is computed as a nonresident under sections 871(a) and (b). Second, an alternative tax calculation is made, under which the expatriate is subject to U.S. tax at rates applicable to and in the same manner as U.S. citizens and residents, except that gross income includes only U.S. source income (as specially defined) and deductions are allowed only to the extent they are connected with such income. The expatriate's U.S. tax liability is the greater of the two amounts. I.R.C. § 877(b).

In making these calculations, the alternative minimum tax of section 55 applies as does the tax on lump sum distributions of section 402(d)(1), until the year 2000, when section 402(d)(1) expires. I.R.C. § 55 (West 1988 & Supp. 1996); I.R.C. § 402(d)(1) (West 1988 & Supp. 1996). The capital loss carryover of section 1212(b) is not allowed, and in addition, casualty losses, charitable contributions, and one personal exemption are allowed, but losses incurred in transaction entered into for profit under section 165(c)(2) are allowed only if any profit would have been U.S. source. *Id.* Note that this treatment of deductions is more favorable than that available to the non-expatriate nonresidents, who can deduct only expenses connected with trade or business income, and a limited category of other deductions and losses. Thus, for example, if an expatriate incurs investment interest in connection with the purchase or holding of investment property, a deduction is allowed. In contrast, if a non-expatriate nonresident incurs the same interest expense with respect to investment property that produces U.S. source income or gain, for instance, stock of a domestic company, no deduction is permitted. I.R.C. § 873(a) (West 1988) (no deductions allowed against gross tax on U.S. source income under section 871(a)).

worth is greater than or equal to $500,000 or more on the date of expatriation, is automatically deemed to have a principal purpose to avoid U.S. taxes.[137]

For expatriates whose income or net wealth does not exceed these thresholds, they are subject to section 877 only if one of the principal purposes for expatriation was the avoidance of U.S. income or transfer taxes. Under section 877(e), once the IRS determines that loss of citizenship would "result in a substantial reduction . . . in the taxes" on the expatriate's income, the burden of proving that a principal purpose for expatriation was to avoid U.S. income or transfer tax is shifted from the Service to the expatriate.[138] Although the intent test of prior law is still potentially applicable to those persons not satisfying the income or wealth test, because wealthy expatriates are automatically subject to section 877, it is unlikely the Service will devote many resources to expatriates not satisfying the income or wealth test. The intent test has thus been de facto revoked.[139]

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137. I.R.C. § 877(a)(2)(A)-(B). "Net income tax" is the sum of the tax liability computed under sections 1 and 55 less the credits allowable under sections 21 through 30. I.R.C. § 38(c)(1) (West 1988 & Supp. 1996). For the taxable year 1996, an unmarried individual with a taxable income of $301,080 would have an income tax liability under section 1(c) of $100,000. To the extent that some of the income was foreign source and subject to a creditable foreign income tax, the taxpayer's net income tax would be reduced. Thus, a taxpayer could have a large taxable income but as long as the U.S. source portion did not exceed $300,000 and was subject to a foreign tax rate more or less equal to the U.S. rate, the section 877(c)(1)(A) test would not be satisfied. Unless the taxpayer was a spendthrift, however, the net worth test would probably be satisfied. These amounts are indexed for inflation for post-1996 calendar years. *Id.*

138. I.R.C. § 877(e). Neither the statute nor the legislative history indicates how much of a reduction in taxes is necessary in order to constitute a "substantial" reduction. The meaning of "substantial" varies from one Code section to the other. *Compare, e.g.*, I.R.C. § 368(a)(1)(C) (West 1988 & Supp. 1996) (acquisition of "substantially all" of acquired company's assets for ruling purposes is 70% of gross assets and 90% of net assets (Rev. Proc. 77-37, 1977-2 C.B. 568)) *with* I.R.C. § 1092 (West 1988 & Supp. 1996) ("substantial diminution" of risk of loss).

The statute does not address whether the term "taxes" in section 877(e) refers to U.S. taxes or foreign taxes, and the absence of any qualifier preceding "taxes" would suggest that the relevant comparison was between the expatriate's worldwide (U.S. and foreign) tax bill and his worldwide tax bill had he remained a citizen. The FITA legislative history, in paraphrasing the burden shifting provision, inserts the parenthetical phrase "(domestic and foreign)" after taxes, thus indicating that Congress believed the relevant comparison was the expatriate's worldwide tax position. *See* H.R. No. 1450, 89th Cong., 2d Sess. (1966). At least one commentator concurs in this interpretation. *See* ISENBERGH, *supra* note 69, ¶ 2.6. In addition, in Di Portanova v. United States, 690 F.2d 169, 176 (Ct. Cl. 1982), the court, following the legislative history, stated that both U.S. and foreign taxes must be considered.

139. Under prior law, section 877 did not apply unless it could be shown that a taxpayer expatriated to avoid U.S. taxes. Determining a taxpayer's intent required substantial administrative resources, which the Service was hesitant to devote towards enforcing section 877. JCT Report 3, *supra* note 9, at 70. Under prior law, because an

Even if the wealth and income tax thresholds are exceeded, however, an expatriate will not be subject to section 877 if a ruling is requested from the Service that one of the principal purposes of expatriation was not to avoid U.S. taxes.[140] The ruling option is only available in four situations.[141] First, if the expatriate was a dual citizen of the United States and another country at birth and continues to be a citizen of such other country, he may request a ruling.[142] Second, the expatriate becomes a citizen of his country of birth, his spouse's country of birth, or the country of birth of either of his parents.[143] Third, the expatriate has spent thirty days or less in the United States for each of the ten years preceding the date of expatriation.[144] This provision should generally affect those persons who are legally U.S. citizens because one parent was a U.S. citizen but who have spent an insignificant amount of time in the United States and may not even know they are citizens. And

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expatriate did not have to notify the Service of a change in tax status, there was little chance of detecting tax-motivated expatriates. On the Form 1040NR, nonresidents must answer whether the taxpayer has ever been a U.S. citizen. This information, however, was apparently not used by the Service to identify persons possibly subject to the expatriate regime. In fact, the Commissioner of the IRS was unaware that such information was being collected. *See* Letter from IRS Commissioner Margaret Milner Richardson to JCT (Apr. 26, 1995), *printed in* JCT Report 3, *supra* note 9, at app. G. Even if the Service discovered an expatriate possibly subject to expatriate regime, administrative resources had to be dedicated to determine a taxpayer's intent in order to rebut the taxpayer's testimony that the principal purposes of expatriation was not tax avoidance. *See id.* Two cases, Kronenberg v. Commissioner of Internal Revenue, 64 T.C. 428 (1975), and Furstenberg v. Commissioner of Internal Revenue, 83 T.C. 755 (1984), reached the issue of whether a principal purpose of expatriation was avoidance of U.S. taxes. It was possible for a taxpayer to allege ignorance of the tax consequences of expatriation, provided advice was given by a lawyer, because of the attorney client privilege. Indeed, in *Furstenberg*, the taxpayer asserted such privilege. *Furstenberg*, 83 T.C. at 761.

140. I.R.C. § 877(c)(1)(A)-(B). The ruling must be submitted within one year from the date of expatriation. The legislative history states that it is expected that the Service take into account factors such as "the substantiality of the former citizen's ties to the U.S. (including ownership of U.S. assets) prior to expatriation, the retention of U.S. citizenship by the former citizen's spouse, and the extent to which the former citizen resides in a country that imposes little or no tax." H.R. REP. NO. 104-736 (1996) [hereinafter CONFERENCE REPORT].

141. The Treasury is given authority to expand the ruling option to include other individuals. The legislative history does not give any guidance as to which individuals should be eligible for this treatment.

142. I.R.C. § 877(c)(2)(A)(i).

143. I.R.C. § 877(c)(2)(A)(ii)(I)-(III).

144. I.R.C. § 877(c)(2)(B) (West 1989 & Supp. 1996). The rules of section 7701(b)(3)(D)(ii) apply to determine days of presence in the United States.

fourth, the person expatriates prior to attaining the age of eighteen and one-half years.[145]

The elimination of the prior intent test for wealthy taxpayers is laudable, because it ensures that the provision is fairly and objectively applied. It is unclear, therefore, why Congress retained any vestige of the intent test. Furthermore, the ruling procedure potentially introduces an unnecessary measure of administrative arbitrariness, and is inconsistent with the use of bright-line income and wealth thresholds. There is no apparent reason why a person should be taxed differently because he returns to his native country or to that of his parents, rather than to, for example, the country where he has his wealth.

Under the FITA expatriate regime, resident aliens were subject to the expatriate income tax regime only if they abandoned U.S. residency and regained it within three calendar years. The expatriation provisions have been expanded to cover certain long-term resident aliens on the same basis as former U.S. citizens.[146] Thus, a former resident alien whose expatriation is tax motivated, i.e., one who exceeds the income tax or wealth thresholds, will be subject to both the income and transfer tax expatriate provisions.

The expatriate provisions apply only to long-term permanent residents, i.e., green card holders whose green card has been either revoked or abandoned or who become residents of another country under an applicable tax treaty.[147] A long-term resident is a person who has been a green card holder for at least eight of the last fifteen taxable years, ending with the taxable year during which the resident alien either gives up or loses his green card or avails himself of treaty benefits.[148] The ruling procedure option is not available to a resident alien subject to section 877.

These provisions raise serious tax policy questions. It is consistent policy to subject both residents and citizens to the expatriate regime, since they are both taxed on their worldwide income. Without such a rule, a wealthy resident alien would have no incentive to become a citizen. The decision to subject only green card holders, however, to the expatriate regime is highly questionable. If Congress has decided that

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145. I.R.C. § 877(c)(2)(C).

146. I.R.C. § 877(e). Congress did not delete section 7701(b)(10), and therefore, it still applies to all residents. It is unclear whether this was legislative oversight or a conscious policy decision to retain the provision.

147. I.R.C. § 877(e)(1)(A)-(B).

148. I.R.C. § 877(e)(2). If an individual is a green card holder and a resident of a treaty country for tax treaty purposes, provided that the person does not waive treaty benefits, he will not be treated as a green card holder for purposes of the long-term residency test.

only those persons who have been residents of the United States for eight of the last fifteen years should be subject to the expatriate regime, any person who has been a resident for such period should be subject to the regime.

One aim of Congress in excluding nongreencard holders from the expatriate provisions may be to exclude holders of "E" visas, which are generally obtained by wealthy businessmen and investors who invest capital in the United States.[149] Congress may have believed that such persons would not continue to invest in the United States if they were subject to the expatriate provisions. However, there does not appear to be any legitimate reason to exclude these persons from the expatriate provisions. Because these visas can be obtained by the wealthy, provided that certain investments are made in the United States, the exclusion of nongreencard residents from the expatriate provisions will certainly encourage wealthy persons, who wish to become U.S. residents without being subject to the expatriate provisions, to buy their way out.

In addition, it is unclear why only green card holders who possess a green card for eight of the last fifteen years are subject to the expatriate regime. Although there may be administrative reasons to exclude persons who are residents for short periods of time, none of them are delineated in the legislative history. Congress intended to subject only persons possessing either substantial net wealth or earning significant amounts of income to the expatriate provisions. Sound tax policy would dictate that all persons leaving residence basis taxation who satisfy these thresholds be subject to the expatriate regime, regardless of the duration of time that they were subject to residence basis taxation. The failure to tax all residents leaving U.S. residence basis jurisdiction may violate the tax policy norms of vertical and horizontal equity: Depending solely on length of residence, former residents with equal post-expatriate U.S. source income may be taxed differently, and former residents with greater U.S. source income may be taxed differently than those with less U. S. source income.

Excluding from the ruling procedure long-term resident aliens who expatriate is also questionable. If they are subject to the burdens of the expatriate regime on the same basis as citizens, they should also be able to demonstrate that their expatriation was not tax motivated on the same

149. *See* AUSTIN T. FRAGOMEN, JR. & STEVEN C. BELL, IMMIGRATION FUNDAMENTALS: GUIDE TO LAW AND PRACTICE 5-35 (1996).

basis as citizens. This rule may have the perverse effect of encouraging persons to become citizens solely to reduce their U.S. tax liability. If a long-term resident alien is considering moving back to his (or his parents') country of origin, he would not be eligible for the exceptions in section 877(c)(2)(A).[150] If he becomes a citizen and then expatriates, he would qualify for the exceptions. There may be an incentive under some circumstances for a long-term resident subject to section 877 to first acquire U.S. citizenship and then immediately abandon it. This may lessen the sanctity of citizenship.

2. *U.S. Source Income and Gains*

Once an expatriate is subject to section 877, he will be taxed at graduated rates on her U.S. source income for ten years following expatriation.[151] One of the principal criticisms of the FITA expatriate regime was that it was easy to convert taxable U.S. source gains into non-taxable foreign source gains through elementary tax planning.[152] In response to these criticisms, the new expatriate regime makes it much more difficult to remove tax-free appreciated assets that produce U.S. source income or the sale of which would produce U.S. source gain. This is accomplished by significantly expanding the definition of items that are U.S. source.

Gains on the sale or exchange of stock of U.S. corporations or debt obligations of U.S. persons are U.S. source.[153] Under section 865, these gains would generally be foreign source if realized by a nonresident.[154] In addition, gains on the sale of personal property located in the United States are U.S. source.[155] This language may be inconsistent with the approach of section 865, which ties the source of sale of personal property to the residence of the seller rather than the location

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150. I.R.C. § 877(c)(2)(A).

151. I.R.C. § 877. More specifically, an expatriate must pay the greater of the alternative tax computed under section 877(b) or under section 871. The 1996 amendments left unchanged the computation of the alternative tax under section 877(b).

152. *See, e.g.*, David S. Zimble, *Expatriate Games: The U.S. Taxation of Former Citizens*, 61 TAX NOTES 617 (1993); Testimony of H. David Rosenbloom before the Subcommittee on Taxation and Internal Revenue Service Oversight of the Senate Committee on Finance, Mar. 21, 1995, *available in* LEXIS, Fedtax Library, TNT File, 95 TNT 56-44 (stating that "Section 877 does not work. . . . Avoiding it is child's play. Administering it in a fair way is impossible.").

153. I.R.C. § 877(d)(1)(A)-(B).

154. I.R.C. § 865(a)(2) (West 1988 & Supp. 1996).

155. I.R.C. 877(d)(1)(A)-(B). The statute states that the sale or exchange of "any property" located in the United States is U.S. source. Since gains from the sale or exchange of U.S. real property are already treated as U.S. source under section 861(a)(5), this provision only applies to personal property.

of the property. If section 865 does not apply to determine the source of other personal property, the source of gain of intangible property, such as copyrights, patents, trust, and partnership interests is unclear.[156]

Under a new anti-abuse rule, income or gain from some controlled foreign corporations ("CFCs") is also treated as U.S. source. Specifically, if the expatriate owned, at any time during the two-year period preceding expatriation, more than fifty percent of the voting power or value of a foreign corporation, the income or gain from the foreign corporation will be treated as U.S. source.[157] The amount of such income or gain treated as U.S. source is limited, however, to the earnings and profits of the corporation earned before expatriation and during the time the ownership tests are met.[158] This rule is probably intended to curtail shifting U.S. assets to foreign corporations in anticipation of expatriation.

When applied to persons who become long-term resident aliens and then expatriate, this rule may be inappropriately harsh. For example, assume that a nonresident alien holds 100 percent of the stock of FC, a foreign corporation, and becomes a long-term resident alien. If she continues to hold the stock and then expatriates, section 877(d)(1)(C)(ii) would treat as U.S. source the income from the corporation attributable to earnings and profits accumulated before the loss of residency and during the period in which the ownership tests were satisfied.[159] Because the ownership requirements may be satisfied even during the pre-residency period, earnings from the foreign corporation that were attributable to the pre-residency period could be treated as U.S. source income. This result is inappropriate: Only the income attributable to the untaxed earnings of FC while the person was a resident alien should be treated as U.S. source. The regulations should clarify that the relevant period is that of U.S. citizenship or residency.

The nonrecognition rules, e.g., sections 351, 368, and 1031, do not apply if property producing U.S. source income is exchanged for

156. The legislative history gives no guidance. Presumably, the source rules of section 865 should apply.

157. I.R.C. § 877(d)(1)(C)(i). If the corporation owns assets that do not produce current income, it will not have any earnings and profits until the assets are sold. The constructive ownership rules used to determine an expatriate's ownership interest are found in I.R.C. § 958 (West 1988).

158. I.R.C. § 877(d)(1)(C)(ii).

159. *Id.*

property producing foreign source income, and consequently gain must be recognized upon the exchange of property.[160] This rule will not apply, however, if the expatriate enters into a gain recognition agreement under which the expatriate agrees to treat as U.S. source any income or gain from the acquired property during the ten-year period.[161] If the acquired property is disposed of, the agreement is terminated and any gain not recognized by reason of the agreement must be recognized on the date of disposition.[162] Thus, for example, if an expatriate transfers stock of a U.S. corporation to a foreign corporation in exchange for stock of the foreign corporation under section 351, the exchange would be taxable unless the expatriate enters into a gain recognition agreement. Also, upon a subsequent disposition of the U.S. stock by the foreign corporation, the deferred gain must be recognized, regardless of the value of the U.S. stock at the time of disposition.[163]

This provision raises some policy questions. First, it allows expatriates to cap the amount of gain subject to U.S. tax by merely transferring appreciated property to a foreign corporation. Assume that an expatriate holds appreciated U.S. stock, and she and another person transfer the stock and other property to a foreign corporation in a section 351 transaction, with the respective stock interests being held forty percent by the expatriate and sixty percent by the other transferor. If a gain recognition agreement is entered into, no gain is recognized upon the initial transfer, but upon a subsequent disposition of the U.S. stock by the foreign corporation, only the deferred gain realized upon the initial exchange must be recognized. Thus, post-exchange gain is not subject to U.S. tax. In contrast, if the expatriate had continued to hold the stock directly, any post-expatriation gain would be treated as U.S. source and therefore subject to U.S. tax.

Furthermore, although the provisions mandating the recognition of gain upon a disposition by the transferee make sense in the context of

160. I.R.C. § 877(d)(2)(A)-(B). The statute is silent as to the treatment of property transferred with built-in losses. Because the statute provides that the property is treated as sold for its fair market value, it appears that any realized loss that would be taken in account under section 877(b) should likewise be taken into account upon a nonrecognition transfer. The statute grants the Service authority to prescribe regulations substituting the 15-year period beginning five years prior to expatriation for the ten-year post-expatriation period for exchanges of property producing U.S. source income for property producing foreign source income. I.R.C. § 877(d)(2)(D). Some guidance in the legislative history as to scope of the regulations would have been useful. In addition, it is unclear how these regulations will mesh with the statute of limitation provisions, since no changes to these provisions were enacted.

161. I.R.C. § 877(d)(2)(C).

162. *Id.*

163. CONFERENCE REPORT, *supra* note 140, at 326.

transfers of property to controlled corporations, they are questionable when the transferee is not controlled by the transferor. It may be impossible for the transferor to know if the transferee subsequently disposes of the acquired property, and it could possibly lead to tax blackmail by the transferee.

The Treasury is granted authority to prescribe regulations that could treat either the removal of appreciated tangible personal property from the United States or other nonrecognition event that results in a change from U.S. to foreign in the source of the income or gain from property as a taxable exchange.[164] The legislative history gives as an example the removal of appreciated artwork by an expatriate, but also states that gain recognition can be avoided by entering into a gain recognition agreement.[165] It is unclear whether a gift of the property to a foreign person would be a taxable event.

Section 877(d)(4) also prevents expatriates from transferring property producing U.S. source income to a foreign corporation and having the foreign corporation earn the income rather than the expatriate shareholder.[166] Under the FITA expatriate regime, an expatriate could transfer property to a foreign corporation tax-free under section 351[167] and have the foreign corporation accrue the income. If the foreign corporation were incorporated in a treaty country, the U.S. tax could be reduced or limited under an applicable treaty provision. In addition, a sale of the property by the foreign corporation would not have been taxed under section 877. To prevent this gambit, under section 877(d)(4), if an expatriate contributes property producing U.S. source income to a controlled foreign corporation, any income or gain earned by the foreign corporation after the contribution will be taxed directly to the expatriate.[168] Consequently, upon a transfer of property producing U.S. source income to a foreign corporation, not only will gain be recognized upon the transfer, but the income from the transferred property will also

164. I.R.C. § 877(d)(2)(E).
165. CONFERENCE REPORT, *supra* note 140, at 326.
166. I.R.C. § 877(d)(4).
167. I.R.C. § 351 (West 1988 & Supp. 1996).
168. A foreign corporation will be treated as a controlled foreign corporation if, assuming the expatriate were a U.S. person, the corporation would have been a controlled foreign corporation under section 957, and the expatriate would have been a U.S. shareholder under section 951(b). I.R.C. § 877(d)(4)(B).

continue to be subject to tax.[169] It is unclear how the Service will monitor such transfers.

The interaction between this rule and the rule requiring gain recognition upon the subsequent transfer of property by the foreign corporation is unclear. For example, assume that an expatriate transfers U.S. income producing property (adjusted basis fifty dollars, FMV $100) to a wholly owned foreign corporation under section 351. If the expatriate enters into a gain recognition agreement, no gain will be imposed. Upon a sale of transferred property by the foreign corporation within the ten-year period, the expatriate must recognize the deferred gain of fifty dollars. In addition, because the corporation is a controlled foreign corporation, the gain realized by the foreign corporation will also be taxed to the expatriate. There is no mechanism to sort out the priority between these two provisions.

The running of the ten-year period is suspended for any period during which the expatriate's risk of loss is "substantially diminished" by holding a put, selling a call, short selling, or any other transaction.[170] The legislative history gives an example of an expatriate who enters into a five-year equity swap with respect to stock and states that during the term of the equity swap the ten-year period is suspended. Neither the statute nor the legislative history delineates the scope of the term "substantial," and it is unclear how much risk must be diminished before the running of the ten-year period will be suspended. For example, if an expatriate holds a diversified portfolio of U.S. stocks and sells options on the S&P 500 so that he hedges twenty percent of the risk of holding his portfolio of U.S. stocks, would that be sufficient to suspend the running of the ten-year period, and if so, for the entire portfolio or only for the portion of the portfolio that is hedged? Although the legislative history is silent, because the language and aim of section 877(d)(3) is similar to that of sections 246(c) and 1092(d)(3)(B), it is likely that the Service will interpret it similarly.[171] It is unclear how the Service will be able to monitor whether an expatriate has diminished his risk of loss.

A former resident alien subject to the expatriate provisions can make an irrevocable election to step up the basis of any property held at the time the person became a resident alien to its fair market value on such date.[172] Thus, for property that is subject to the tax under section 877,

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169. If the shareholder is taxed directly on the income of the foreign corporation, will he receive a credit for any U.S. tax paid by the corporation?

170. I.R.C. § 877(d)(3).

171. This provision, although necessary to prevent easy avoidance of section 877, may be impossible to enforce, especially in the case of hedges by related persons.

172. I.R.C. § 877(e)(3)(B).

any pre-residency gains are eliminated, but pre-residency losses are not. The limited scope of the election to step up the basis of property held by a former resident alien prior to becoming a resident alien is questionable. Because it applies solely for purposes of determining the tax imposed under section 877, it may exacerbate the lock-in effect. For example, assume that a nonresident holds U.S. stock with a basis of $500,000 and a value on the date of acquiring U.S. residency of one million dollars, and plans to remain a resident for at least eight years. Any sale during the period of residency will produce a taxable gain if the amount realized is greater than $500,000, whereas any sale after residency is abandoned will produce a taxable gain only if the amount realized in greater than $1 million.[173]

3. Double Taxation

During the expatriate tax debate, many commentators voiced concern that mark-to-market taxation upon expatriation could result in double taxation if the expatriate were taxed on the same gain by his new country of residence. If an expatriate were subject to double tax, she could effectively be impeded from exercising her right to expatriate.[174] Commentators noted that under the FITA expatriate regime, double taxation could also occur.[175] Under section 877(b), an expatriate may take a credit against his U.S. income taxes for foreign income taxes paid "on any income of the taxpayer on which tax is imposed solely by reason of this section."[176] The legislative history adds that the credit "is not available to be used to offset any other U.S. tax liability," and gives an example of an expatriate who realizes gain by selling stock of a U.S. corporation and is taxed on the gain by the United States and a foreign country.[177] The scope of this provision, however, is unclear.

173. Even though a longer holding period may mean that the person is subject to the risk that price of the stock may decline, it may be possible to hedge away the risk by a short sale, put option, equity swap, albeit at the cost of the hedge. The source of gains from the sale of options, closing out a short sale of stock, or payments under an equity swap for purposes of section 877(d) are unclear.

174. *See, e.g.*, NYSBA Report, *supra* note 115, at 12.

175. *See, e.g.*, Testimony of Stephen E. Shay before the Subcommittee on Oversight of the House Committee on Ways and Means, Mar. 27, 1995, *available in* LEXIS, Fedtax Library, TNT File, 95-TNT 69-67.

176. I.R.C. § 877(b).

177. CONFERENCE REPORT, *supra* note 140, at 328.

For example, assume that an expatriate subject to section 877 owns stock of a U.S. corporation and receives a dividend from the corporation. If the expatriate's dividend and other U.S. source income is large enough, the tax imposed under section 877 will exceed the thirty percent tax under 871. In such case, will a credit be available for none, part, or all of the foreign taxes imposed on the dividends?

B. Expatriate Wealth Transfer Tax Provisions

The approach of the expatriate transfer tax regime is similar to that taken with respect to income taxes. The underlying policy is to reduce the incentive to expatriate for tax-motivated reasons by attempting to equalize an expatriate's transfer tax liability with respect to U.S. situs property with that had she not expatriated. The expatriate transfer tax regime applies if expatriation had as one of its principal purposes the avoidance of income, gift, or estate taxes.[178] The same rules of the expatriate income tax regime apply to determine whether a person expatriated to avoid U.S. transfer taxes.[179] Once the requisite showing of tax-avoidance intent is made, an expatriate is subject to the expatriate transfer tax regime for ten years (or the date of death if shorter) following expatriation.

If the expatriate gift tax regime applies, the expatriate is subject to U.S. gift taxes on transfers of both tangible and intangible U.S. situs property.[180] Thus, a gift of stock of a U.S. corporation is subject to

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178. I.R.C. §§ 2107, 2501(a)(3) (West 1988 & Supp. 1996). The interaction of the expatriate regime and the generation skipping tax is unclear. When the FITA expatriate regime was enacted, there was no generation skipping tax. Consequently, there are no special expatriate generation skipping tax rules. In addition, because final generation skipping tax regulations applicable to nonresidents were not issued until 1996, it would have been difficult to determine whether an expatriate renounced his citizenship to avoid generation skipping taxes. Both the expatriate estate and gift tax regimes, however, apply to any tax-motivated expatriate whose expatriation had as one of its principal purposes the avoidance of subtitle B of the Code, which includes the generation skipping tax. Since under final generation skipping taxes, a nonresident is subject to generation skipping tax if the initial transfer would have been subject to estate or gift tax, the issue thus arises whether the regular or expatriate estate and gift tax rules apply. Conceptually, the better answer is that for tax-motivated expatriates, in determining whether a transfer would be subject to estate or gift taxes, the expatriate estate and gift tax rules should apply. The statutory language, however, is probably insufficient to support this conclusion in all circumstances. For example, assume that John, a tax-motivated expatriate, holds the appreciated IBM stock worth $11 million, and gifts it to his grandchild. Under section 2511(b)(1) (West 1989), the stock would be U.S. situs and therefore subject to gift tax. The same section provides, however, that the stock is U.S. situs "[f]or purpose of [chapter 11]." I.R.C. § 2511(b). The generation skipping tax is not found in chapter 11, but rather in chapter 13.

179. I.R.C. §§ 2017, 2501(a)93)(B) (West 1989).

180. I.R.C. §§ 2501(a)(2), 2511(a).

U.S. gift tax. In contrast, a nonresident not subject to expatriate gift tax would not be subject to gift tax upon the transfer of stock of a U.S. corporation. The rates applicable to such transfers are the same rates applicable to other taxable transfers of U.S. situs property by nonresident aliens. Stock of a foreign corporation, however, is not U.S. situs property for gift tax purposes, regardless of whether its assets consist entirely of U.S. situs assets.[181] In addition, debt obligations of U.S. obligors are also treated as U.S. situs property.[182] Again, this rule subjects transfers that would otherwise be tax free to U.S. gift tax. For other property, the determination of situs follows the general situs rules discussed above.[183]

If the expatriate estate tax regime applies, the expatriate is subject to estate tax on U.S. situs property like other nonresidents.[184] In addition, the value of stock of a closely held foreign corporation that owns U.S. situs assets is part of the expatriate's taxable estate.[185] This rule prevents an expatriate from transferring U.S. situs property to a foreign corporation and avoiding U.S. estate tax by bequeathing the stock of the foreign corporation rather than the underlying U.S. assets. However, a tax-motivated expatriate can avoid U.S. estate tax on U.S. situs assets by transferring the assets to a foreign corporation (albeit at the cost of recognizing gain), provided the ownership thresholds are not exceeded. The stock of the foreign corporation can also be gifted free of U.S. transfer tax.

Section 2107 now provides a credit for foreign death taxes, but only for property included in the decedent's gross estate "solely by reason of [section 2107](b)."[186] The credit is thus allowed only for foreign death

181. Treas. Reg. § 25.2511-3(b)(3)(ii) (as amended in 1973).
182. I.R.C. § 2511(b)(2).
183. *See supra* notes 49-57 and accompanying text.
184. I.R.C. § 2107(a)-(b) (West 1989 & Supp. 1996); I.R.C. § 2103 (West 1989).
185. If at death (within 10 years of expatriation), the expatriate owned directly or indirectly 10% or more of the voting stock of the foreign corporation, and also owned directly, indirectly, or constructively more than 50% of the vote or value of the foreign corporation, then the value included in the decedent's estate is equal to the value of the foreign corporation directly or indirectly owned by the decedent times the portion of the total assets of the foreign corporation consisting of U.S. situs property. *Id.*
186. I.R.C. § 2107(c)(2). Under section 2107(b), an expatriate's gross estate includes U.S. situs assets under section 2103 as well as the value of stock of certain controlled foreign corporations with U.S. situs assets. More specifically, the foreign tax credit is the lesser of two amounts. The first is determined by multiplying the amount of foreign death taxes "in respect of property included in the gross estate" by a ratio

taxes imposed with respect to stock of a controlled foreign corporation with U.S. situs assets. In addition, a credit for foreign gift taxes imposed solely by reason of section 2501(a)(3), e.g., a gift tax on the transfer of U.S. stock and debt of U.S. obligors, is also permitted.[187]

C. *Income Tax Treaties*

One of the weaknesses of the FITA expatriate regime was that it could be avoided entirely if the expatriate was a resident of a country with which the U.S. had an income tax treaty and under which the U.S. did not reserve the right to tax expatriates.[188] To remedy this, Congress provided that the expatriate provisions, as amended in 1996, shall "not be defeated by any treaty provision."[189] The Treasury is directed to

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consisting of the property included in the gross estate solely by reason of section 2107(c) and all property subject to foreign death taxes. I.R.C. § 2107(c)(2)(B)(i). The second limitation is calculated by multiplying the ratio consisting of the property included in the gross estate solely by reason of section 2107(c) and all property included in the gross estate by the difference between the expatriate's estate tax liability computed under the regular nonresident estate tax regime and under the expatriate estate tax regime. *Id.*

This provision appears to suffer from faulty drafting. The aim of the provision is to determine the foreign death taxes applicable to the property included in the gross estate solely by reason of section 2107(b) without having to precisely match the foreign death taxes applicable to the property. When there are progressive rates or zero bracket amounts, matching imposes severe administrative burden. In essence, this provision determines the foreign death taxes applicable to the U.S. situs property by using the average foreign death tax rate. Accordingly, the multiplicand should be the foreign death taxes applicable to all property, not merely the property "included in the gross estate." Also, it is unclear why the first limitation permits the crediting of foreign death taxes imposed on property that is not situated within the foreign sovereign's demesne. It appears to create a conflict with the policy of section 2014(b) and permits expatriates a more favorable foreign tax credit regime than that applicable to citizens and residents.

For example, assume that an expatriate dies owning property worth $10 million, of which $1 million is included in the gross estate solely because of section 2107(b) and $9 million is foreign situs property. If the foreign death tax rate is 60% and the U.S. rate is 50%, the expatriate may credit $550,000 against his U.S. estate tax liability of $550,000 [$1 million gross estate times 55%], calculated as follows:

1st limitation: $1 million (property included in gross estate solely under section 2107(b)/$10 million (value of all property subject to foreign tax) times $6 million (foreign death taxes paid) = $600,000.

2nd limitation: 100% (value of 2107(b) property bears to property in gross estate) times $550,000 [section 2017 tax ($550,000) less tax imposed by section 2101 excluding section 2107 ($0)]= $550,000.

187. I.R.C. § 877(d)(1)(E) (West 1988 & Supp. 1996).

188. Crow v. Commissioner, 85 T.C. 376, 392-93 (1985). For a listing of treaties and a comparison of different savings clauses, *see* JCT Report 3, *supra* note 9, at A-1 to A-3.

189. CONFERENCE REPORT, *supra* note 140, at 326. The legislative history states, somewhat curiously, that Congress believes that the expatriate provisions are consistent with "underlying principles of income tax treaties to the extent [a foreign tax credit is provided]." *Id.*

review all outstanding treaties to determine if a treaty conflict exists and to eliminate any such conflict by negotiation. The legislative history provides that this override of treaties will remain in force only until the tenth anniversary of the enactment of the amendments. Any treaty with a savings clause that does not specifically refer to former citizens would provide protection against the expatriate provisions.[190]

This is the first time that Congress has overridden existing income tax treaties for a limited future period. Although Congress has overridden income tax treaties, and has shown a greater propensity to do so in the last decade, it generally has done so only when there has been a significant change in either U.S. tax law or tax policy so as to prevent an unbargained-for benefit to taxpayers or treaty partners.[191] The amendments to the expatriate provisions do not represent a significant change in U.S. tax policy; the policy embodied in section 877 remains the same as under prior law, but merely the scope of the provision has been expanded. One consequence of the ten-year override is that foreign countries may now extract fiscal concessions from the United States in exchange for the renegotiations. One can expect, however, that if the concessions demanded by foreign countries in exchange for amending treaty provisions are too onerous, the ten-year period will probably be extended.[192]

D. Summary

Although the 1996 amendments of the FITA expatriate regime significantly ameliorated some of the FITA expatriate regime's more egregious technical shortcomings, the expatriate provisions still do not reflect sound tax policy. Because foreign source gains that accrue during citizenship or residency are not subject to section 877, persons contemplating expatriation have an incentive to forego investments in the U.S., thereby distorting the allocation of capital. Likewise, expatriates

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190. JCT Report 3, *supra* note 9, at 129. The applicable treaties—those containing a Category I savings clause—are listed at Appendix A of the JCT Report 3.

191. *See* S. REP. NO. 100-445, at 376-77 (1988).

192. One issue that arises is the effect of treaties that are subsequently approved, but do not contain a savings clause permitting the United States to tax its former resident aliens. This could occur in the case of treaties that were negotiated by the United States prior to the 1996 amendments but approved after the amendments. When there is a conflict between a treaty and a statute, the general rule is that the more recent expression of the intent of the sovereign controls. Consequently, the treaty provision should control.

who are identically situated will pay significantly different amounts of U.S. tax, and "poorer" expatriates could pay more taxes than "well off" expatriates, thereby raising questions of tax fairness. Even for those expatriates with U.S. source property, section 877 can be avoided as long as the property is not sold within the ten years following expatriation. The risk of holding property may be reduced possibly through related party hedging. The expatriate transfer regime is easily avoided by holding property in foreign corporate solution and making inter-vivos transfers of the foreign stock.

VI. U.S. Tax Issues That Arise When a Person or Property Becomes Subject to Residence or Trade or Business Basis Taxation

The previous section discussed the U.S. tax consequences of a person ceasing to be taxed on a residence basis. Similar issues arise when a person becomes subject to U.S. residence basis taxation or property owned by a foreigner (including a foreign corporation) becomes part of a U.S. trade or business. Congress has focused little attention on persons or property entering U.S. tax jurisdiction. This neglect is surprising, because the approach of the current law may unnecessarily short change the U.S. fisc under many circumstances.

When property enters U.S. tax jurisdiction, either by being used in a U.S. trade or business or by its owner becoming a U.S. citizen or resident, such a change in tax jurisdiction has traditionally been treated as an event with no tax consequences. Upon a subsequent sale of the property, gain or loss is calculated using the historical dollar basis of the property, and consequently, pre-residency gain or loss can be subject to or reduce U.S. income tax. Because pre-residency gain can be subject to U.S. income tax, a nonresident who is contemplating becoming a resident or citizen is advised to realize gains prior to becoming a resident or citizen, and realize losses after becoming a resident or citizen. In essence, the tax on pre-residency appreciation is a tax on the poorly advised, and causes persons who are similarly situated to have different U.S. income tax liabilities.

This section will discuss the income tax issues raised by persons entering U.S. residence basis jurisdiction and persons leaving U.S. residence basis jurisdiction who are not subject to the expatriate tax regime of section 877. Many important questions remain unanswered, and because there appears to be no coherent tax policy for persons and property entering U.S. tax jurisdiction, similar transactions can yield different U.S. tax results.

A. Taxable Year

For the year during which an alien becomes a resident alien (or a resident alien or citizen ceases to be taxed on a residence basis), the alien's taxable year is bifurcated, and she is taxed on a source basis while nonresident and on a residence basis while resident.[193] Thus, the U.S. tax consequences to a person receiving (accruing) income or paying (accruing) an expense are determined based "on the status of the foreign taxpayer at the time of receipt or payment (or . . . accrual)."[194] This simple rule, however, is deceptively difficult to apply.

Once an alien determines exactly when her U.S. tax residence begins,[195] to compute her U.S. income tax liability for the year of change and subsequent years, she must also determine her taxable year and method of accounting. As a resident alien, she must file an income tax return and report her income on the basis of her taxable year.[196] The taxable year may be either a calendar year (ending on December 31) or a fiscal year (ending the last day of any month except December).[197]

Upon becoming a U.S. resident, an alien must report income on the basis of a calendar year, unless the person had previously established a fiscal year in a foreign country prior to becoming subject to U.S. income tax either as a resident or nonresident.[198] If either a fiscal or calendar

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193. Treas. Reg. § 1.871-13(a)(1) (as amended in 1980). For an excellent discussion of tax accounting issues that arise when foreign persons become subject to U.S. tax, see Harvey P. Dale, *Tax Accounting for Foreign Persons*, 37 TAX L. REV. 275 (1982). The regulation further provides that in determining the taxable income that is subject to graduated rate taxation under section 1, all income earned during the period in which the alien is a U.S. resident is combined with all U.S. trade or business income earned while nonresident. *Id.* This rule is intended to prevent splitting income subject to graduated rates on a net basis between the two periods, and thereby achieve two runs up the progressive tax rate tables.

194. *Id.*

195. The rules for determining when an alien's residence begins and ends are set out in I.R.C. § 7701(b)(2) (West 1989 & Supp. 1996) and Treas. Reg. § 301.7701(b)-4 (1992).

196. I.R.C. § 441(a) (West 1988 & Supp. 1996).

197. I.R.C. §§ 441(b)(1), (d)-(e). A taxable year can also cover a period of less than one year—a short-year return—for example, in the case of death. I.R.C. § 441(b)(3). Under some circumstances, a taxpayer may elect a 52-53 week taxable year. *See* I.R.C. § 441(f).

198. I.R.C. § 7701(b)(9)(A); Treas. Reg. § 301.7701(b)-6(a) (1992). Section 7701(b)(9)(A) is stated in sweeping terms: "For purposes of [the Internal Revenue Code], ..." It therefore literally applies to both resident and nonresident aliens. The

taxable year has been established for any period the alien was subject to U.S. income tax as either a resident or nonresident (because he was engaged in a U.S. trade or business), the alien may not change that taxable year without permission of the Service, apparently regardless of the period of time that may have passed between the establishment of the original taxable year and a subsequent year in which the individual is again subject to U.S. income tax, and apparently regardless of any changes in the alien's taxable year in his foreign country.[199] Even if an alien had previously established a fiscal taxable year, provided the alien was never subject to U.S. income tax, the regulations permit adoption of a calendar year as his taxable year without the usual requirement of requesting a change in accounting period from the Service.[200]

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rule mandating adoption of the calendar year as an alien's taxable year thus arguably could apply for all purposes of the Code, even for nonresident aliens not subject to U.S. taxation. If the rule is intended to apply to nonresident aliens, a more obscure location for the rule could probably not be found. In determining whether a fiscal year has been established either in the U.S. or abroad, the regulations require a taxpayer to have computed her income on a fiscal year basis, kept books in accordance with that fiscal year, and satisfied the requirements of section 441. *Id.*

199. Treas. Reg. § 301.7701(b)-6(a). The regulations evince a notable change from the Service's previous position regarding the election of a taxable year by a taxpayer that had not been previously subject to U.S. tax jurisdiction. In Rev. Rul. 80-352, 1980-2 C.B. 160, the Service ruled that a nonresident alien, A, engaged in a U.S. trade or business could adopt a fiscal year accounting period for the individual's first U.S. income tax return without requesting permission from the Service, even though the taxpayer had previously established a calendar year accounting period in the foreign country. The rationale for the ruling was that since A had previously not been subject to U.S. income tax, A was not a U.S. taxpayer under section 7701(a)(14). Consequently, when A became engaged in a U.S. trade or business and was required to File a U.S. income tax return, A was a new taxpayer within the meaning of regulation section 1.441-1(b)(3) and thus could adopt any taxable year satisfying the requirements of section 441. Although regulation section 301.7701(b)-6(a) overturns the specific holding of Rev. Rul. 80-352, it is not clear whether the rationale of the ruling that foreigners never previously subject to the U.S. income tax are not U.S. taxpayers under section 7701(a)(14) has also been abandoned or rejected. *See* Jose E. More v. Commissioner of Internal Revenue, 66 T.C. 27 (1976), *aff'd without opinion*, 562 F.2d 38 (2d Cir. 1977) ("taxpayer" includes any person that would have been subject to U.S. taxation if the person had received income from within the United States; I.R.C. § 443(a)(2), addressing taxpayers not in existence for entire taxable year inapplicable) and other authorities discussed in Dale, *supra* note 193, at 277-78 n.11.

200. Treas. Reg. § 301.7701(b)-6(a). One issue not squarely addressed by the regulations is whether being subject to taxation under section 871(a), which imposes a thirty per cent gross tax on investment income from U.S. sources, constitutes "being subject to United States income tax as a resident or a nonresident" for purposes of regulations section 301.7701(b)-6(a). All pertinent examples in the regulations illustrate the "subject to U.S. income tax" phrase with examples of foreign taxpayers being subject to U.S. taxation under section 871(b), which subjects persons engaged in a U.S. trade or business to U.S. taxation under section 1. A literal reading of the regulations would seem to suggest that "U.S. income tax" includes both taxes imposed under sections 871(a) and (b), but such a reading leads to strange results. For example, assume that a

The legislative history to section 7701(b) indicates that Congress was concerned that under prior law, being able to elect a fiscal year, especially in the year of change of status, was inappropriate as it permitted a new resident to shift income into more than one fiscal year.[201] At a minimum, this gambit could allow at least two runs up the section 1 rate schedules. For example, assume an alien becomes a resident on July 30, and is going to receive $50,000 on October 30, and $50,000 on November 30. If an October fiscal year were claimed, and assuming no other income was earned, each $50,000 would be taxed in separate years with the benefit of two runs up the section 1 rate schedules.[202]

There may be collateral consequences to the adoption of a taxable year by a person changing U.S. tax status. For instance, if the new resident alien owns directly, indirectly, or constructively a substantial portion of the shares of a controlled foreign corporation or foreign personal holding company, the corporation may be required to adopt the taxable year of the resident alien.[203] In addition, if the new resident alien is a partner in a partnership, either foreign or domestic, the partnership may have to change its taxable year.[204]

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calendar year nonresident alien buys one share of stock of IBM and receives a dividend in 1980 and is subject to tax under section 871(a) on the dividend, but otherwise has no contact with the United States. Assume that the individual changes her taxable year in 1982 to a fiscal year and continues to use a fiscal year when she moves to the United States in 1996. A literal reading of the regulations would seem to require that she use a calendar year taxable year because she had not established a fiscal year as her taxable year prior to being subject to U.S. income tax. *See* Dougherty v. Commissioner of Internal Revenue, 60 T.C. 917 (1973) (holding that foreign corporation can have a taxable year even though it received no income subject to U.S. income tax).

201. STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 463 (Comm. Print 1984). The ability to elect a fiscal year could be especially advantageous for the year of change of status since it would allow the resident alien to sidestep the bifurcated taxable year rules of regulation section 1.871-13.

202. This problem exists, however, any time that a new resident, even a calendar year taxpayer, is able to defer income. Thus, in this example, even if the new resident had adopted a calendar year and was able to delay the second payment until January, the same result would occur.

203. *See* I.R.C. § 898 (West 1988 & Supp. 1996).

204. I.R.C. § 706 (West 1988 & Supp. 1996). The purpose of these rules is to reduce the deferral of income that can result from a partnership having a different taxable year than its partners. Section 706 does not address the issue of partnerships with foreign partners. *Id.* Because such partners could be tax exempt (depending how income is allocated) even though the partnership is engaged in a U.S. trade or business,

B. *Accounting Methods*

A taxpayer's taxable income is computed for his taxable year in accordance with "the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books."[205] The two general categories are the cash and accrual methods.[206] A taxpayer elects his method of accounting on his first return.[207] In addition, certain Code sections permit or require a taxpayer to use a method of accounting for particular transactions or with respect to items of income, for example, the percentage of completion method, installment sales method, and mark-to-market method for securities dealers.[208] Issues analogous to those discussed above in connection with the election of a taxable year arise for persons electing a method of accounting. Thus, it is not entirely clear whether a new resident alien may elect, at his discretion, to compute taxable income on the cash or accrual method for the first taxable year that he is subject to U.S. income tax.[209]

C. *Income and Deductions*

Under regulations section 1.871-13, income received by a resident alien is subject to U.S. tax even though it may be attributable to events

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the issue of deferral may be less relevant than in the context of a partnership with all U.S. partners. Temporary regulations issued under section 706 disregard partners that are tax exempt under section 501. Temp. Treas. Reg. § 1.706-3T(a) (1996). Perhaps the same rational should be applied to partnerships engaged in a U.S. trade or business with foreign partners.

205. I.R.C. § 446(a) (West 1988). This rule is subject to the proviso that any method chosen clearly reflect income. I.R.C. § 446(b).

206. I.R.C. § 446(c)(1)-(2).

207. Treas. Reg. § 1.446-1(e)(1) (1996).

208. I.R.C. § 446(c)(3). The percentage of completion method is set out in I.R.C. § 460 (1996), the installment sales method in I.R.C. § 453 (West 1988 & Supp. 1996), and the mark-to-market method for securities dealers in I.R.C. § 475 (West 1988 & Supp. 1996). Another example of a mandated method of accounting is that for notional principal contracts under Treas. Reg. § 1.446-3 (1996).

209. The issue is whether a nonresident who becomes a resident alien is a new taxpayer for purposes of I.R.C. § 7701(a)(14) (West 1989 & Supp. 1996). If not, the method under which he computed income as a nonresident alien would have to be continued as a new resident alien. If a new resident alien is treated as a new taxpayer, upon becoming a resident alien, the taxpayer should be able to elect, under Treas. Reg. § 1.446-1(e) (1996), either the cash or accrual method, provided that he keeps his books and records on that basis, and it properly reflects income. Because the language of the cited regulation ties the election of a method of accounting not only to the existence of the taxpayer but also to filing a return, the better answer may be that a new resident alien should be able to elect either method.

occurring prior to the person's becoming a resident alien.[210] For example, wages received by a resident alien attributable to services performed outside the U.S. prior to becoming a resident alien are subject to U.S. tax. Likewise, interest that accrued prior to U.S. residency is taxable if received by a resident alien.[211] For cash basis taxpayers, this rule is simple to apply, but operates to the advantage of those taxpayers who are well advised and can accelerate items of income prior to becoming a resident alien, or defer income upon leaving U.S. residency. In tax argot, it is a trap for the unwary.

The time of receipt rule is also conceptually at odds with the approach of two recent amendments to the Code, sections 864(c)(6) and (7), which address an analogous issue and tie the taxation of certain types of income and gain not to the status of the taxpayer at the time of actual receipt but to the status when the activities giving rise to the income occurred.[212] Prior to 1986, nonresident aliens and foreign corporations that were engaged in a U.S. trade or business could substantially reduce their U.S. taxes by either deferring income or gain attributable to that U.S. trade or business to a year in which they were not engaged in a U.S. trade or business.[213] This possibility arose because of the language of section 864(c)(1)(B), which states that if a nonresident alien or foreign corporation is not engaged in a trade or business within the U.S. during the taxable year, no income gain or loss is treated as effectively connected.[214] The gambit of deferring income and gain attributable to a year in which a nonresident alien or foreign corporation was engaged in a trade or business to a year in which the nonresident alien or foreign corporation was not engaged in a trade or business was, in addition,

210. Treas. Reg. § 1.871-13(b), (e) (1996). For accrual basis taxpayers, the taxability of the income should depend on when the income is accrued. The regulations do not provide guidance for accrual basis taxpayers, but merely state that the moment of receipt approach "may not apply to an individual who for the taxable year uses an accrual method of accounting." Treas. Reg. § 1.871-13(d).

211. Treas. Reg. § 1.446-2 (1996) (accrued interest taken into account under taxpayer's method of accounting). *See also* Treas. Reg. § 1.988-2(b) (1996) (translation of accrued interest in nonfunctional currency).

212. Treas. Reg. § 1.864 (1996).

213. In the case of wages, the payments would have constituted FDAP and consequently been subject to 30% tax under section 871(a), but if the nonresident was a resident of a treaty country, the tax could be called off. I.R.C. § 871 (West 1988 & Supp. 1996).

214. Treas. Reg. § 1.864 (1996).

expressly sanctioned in the regulations.[215] Sections 864(c)(6) and (7) curtail this strategm by tying the taxability of such income received in a year during which a nonresident alien or foreign corporation is not engaged in a U.S. trade or business to whether it would have been taxable had it been received while the foreign person was engaged in a U.S. trade or business.

Although sections 864(c)(6) and (7) abandon the time of receipt approach, because of faulty drafting, their scope is quite narrow, and these sections probably do not apply to any situation covered by regulation section 1.871-13. Assume that a resident alien performs services in the U.S. and receives compensation for these services in a subsequent year when she is no longer a resident alien. It appears that the taxability of such amounts would not be determined under section 864(c)(6).[216] Such amount would be an amount taken into account for a taxable year and attributable to the performances of services in another taxable year. Section 864(c)(6) merely determines, however, whether the income would be taxable under section 871(b) had it been taken into account in the previous year and disregarding whether the nonresident is engaged in a U.S. trade or business for the current year. Applying the statute, the income would not have been taxable under section 871(b) in the previous year, but rather under section 1, because the person was a resident alien.[217]

Section 864(c)(7) also raises policy issues. It appears that under section 864(c)(7), even gain accruing after the asset is removed from a U.S. trade or business is subject to U.S. taxation, and there is no

215. *See* Treas. Reg. § 1.864-3(b), (1996) (sale of property on installment sale method during year in which taxpayer engaged in a trade or business and receipt of sale proceeds in year in which not so engaged) and Example 3 (receipt of bonus attributable to services performed in U.S. in year during which taxpayer not engaged in a U.S. trade or business). Ten years later, the regulations still stand, unamended to reflect the 1986 changes. *Id.*

216. Treas. Reg. § 1.864 (1996).

217. It should be noted that section 871(b) states that a nonresident engaged in a U.S. trade or business is taxable under section 1, 55, or 402(d)(1) on effectively connected income. I.R.C. § 871(b). Thus, it may be possible to argue that the reference in section 864(c)(6) to section 871(b) could also be read as a reference to section 1. It should also be noted that section 864(c)(6) only applies to income received in another taxable year and thus, even if it were interpreted to apply to income earned by a resident alien and received when the person was a nonresident alien, section 864(c)(6) would not apply as long as the income were paid in the same taxable year. This conclusion follows from regulations section 1.871-13, which provides that a change of status merely bifurcates that current taxable year but does not create two separate taxable years. Treas. Reg. § 1.871-13 (1996).

statutory mechanism to deduct the expenses incurred in the sale.[218] Furthermore, the source of gains on the sale or exchange of property removed from a U.S. trade or business and exactly how the subsequent sale is to be recast is unclear. The statute gives no guidance other than by deeming the sale to have occurred immediately before the property left the U.S. trade or business.[219] Section 864(c)(7) merely removes the requirement that the taxpayer be engaged in a trade or business; the gain must nevertheless still be treated as effectively connected in order to be taxed under section 871(b). If the gain is U.S. source, taxation will result; if the gain is foreign source, it is treated as effectively connected only under the limited circumstances set out in section 864(c)(4). The source of the gain is also important in determining the taxpayer's foreign tax credit if foreign taxes are paid with respect to the gain.[220]

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218. *See* SEN. REP. NO. 445, 100th Cong., at 355 (1988); *see also* City Bar Report, *supra*, note 14, at 919. It appears that this is the view of the Treasury. *See* Technical Explanation of the U.S.-German Income Tax Treaty, *reprinted in* 2 TAX TREATIES (CCH) 28,151 (Aug. 29, 1989). For a discussion of how section 864(c)(6) has been incorporated into U.S. tax treaties, *see* Meenakshi Ambardar, *The Taxation of Deferred Compensation under IRS § 864(c)(6) and Income Tax Treaties: A Rose is not Always a Rose*, 19 FORD. INT'L L.J. 738 (1995).

219. For a discussion of other interstices of section 864(c)(7), see ISENBERGH, *supra* note 69, ¶ 21.19. It is safe to conclude that the Services will expansively interpret section 864. *See, e.g.*, Priv. Ltr. Rul. 96-11-042 (Dec. 14, 1995) (stating that interest paid on a loan that the bank made while engaged in a U.S. trade or business would be treated as effectively connected under section 864(c)(7) even if the foreign bank's U.S. branch were subsequently closed and the interest were received after the branch was closed).

220. Under sections 901 and 906, nonresident aliens and foreign corporations are permitted a foreign tax credit only if engaged in a trade or business and only with respect to effectively connected income. I.R.C. §§ 901, 906 (West 1988 & Supp. 1996). Under section 906(b)(1)(A) and (B), a foreign tax credit is not permitted against U.S. source effectively connected income if the foreign tax is levied on a residence basis; for such income, a foreign tax credit is permitted only if the foreign country would tax it on a source basis. I.R.C. § 906(b)(1)(A), and (B). Furthermore, in applying the section 904(a) limitation, a taxpayer's taxable income includes only effectively connected income. I.R.C. § 906(b)(2). It is unclear whether gain or income taxed under section 864(c)(6) or 864(c)(7) and by a foreign country in a year during which the nonresident alien or foreign corporation was not engaged in a U.S. trade or business would be creditable under sections 901 and 906. Some commentators have argued that the credit should be allowed on the grounds that section 906 is intended to grant a credit when the taxpayer is subject to foreign tax on effectively connected income, which is how sections 864(c)(6) and 864(c)(7) function. *See* 3 BITTKER & LOKKEN, *supra* note 25, ¶ 69.9 at 69-130.

Deductions and expenses, following the general approach of the regulations, should be taken into account when incurred (for cash basis taxpayers, when paid). The regulations give little guidance with respect to expenses and deductions; the only expense specifically mentioned is the personal exemption, which is limited to one per year.[221] This rule is sound because it is clear the split taxable year for purposes of the regulations does not create two taxable years, but merely bifurcates one taxable year and taxes the income under two separate regimes.[222] One court has ruled that dual status taxpayers may elect the standard deduction in full, but the Service takes the view that no standard deduction is permitted.[223]

One commentator has suggested that certain deductions, such as the standard deduction and personal exemption, should be permitted in their entirety, limited by the income earned during the period of residence basis taxation. His argument is based on grounds of administrative simplicity, and that the effect of these provisions is to merely reduce tax rates.[224] If, however, the standard deduction and personal exemption are viewed as a minimum subsistence amount representing unavoidable expenses,[225] then it probably makes sense to view these "expenses" as incurred ratably over the taxable year. Accordingly, these amounts should be prorated over the portion of the year they are deemed to be incurred.[226]

D. *Income From Entities*

Another issue that arises for dual status taxpayers is how to treat income that is earned by an entity and taxed either solely at the owner

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221. Treas. Reg. § 1.871-13(d)(2) (1996). The regulations also limit the total amount of exemptions under section 151 that may be deducted against taxable income earned during the portion of the year for which the taxpayer is subject to residence basis taxation to his taxable income, before any deductions under section 151. *Id.*

222. *See* More v. Commissioner, 66 T.C. 27 (1976), *aff'd without opinion*, 562 F.2d 38 (2d Cir. 1977); Nico v. Commissioner, 565 F.2d 1239 (1977).

223. *See* Nico v. Commissioner, 565 F.2d 1239 (1977). The Service's position is set out in Rev. Rul. 64-60, 1964-1 C.B. 84. *Accord*, Rev. Rul. 73-62, 1973-1 C.B. 57; Rev. Rul. 74-239, 1974-1 C.B. 372. For the period of nonresidence, no standard deduction is permitted. I.R.C. § 63(c)(6)(B) (West 1988 & Supp. 1996).

224. Dale, *supra* note 193, at 304-05.

225. DODGE, *supra* note 24, at 117.

226. Note that a different result obtains in a somewhat analogous situation: the birth of a child. Under section 151, a deduction in full is permitted for a dependent child, regardless of when during the year the child was born. Treas. Reg. § 1.152-1(b) (1971). In addition, the child is permitted a standard deduction under section 63 of $500 (or its earned income, if greater) without regard to the number of days during the taxable year the child is living. I.R.C. § 63. *Cf.* I.R.C. § 444(c) (West 1988 & Supp. 1996) (personal exemption pro rated when taxpayer changes annual accounting period).

level or required to be included in the owner's income regardless of actual receipt. This occurs in the case of partnerships, FPHCs, PHCs, CFCs, PFICs, trusts, estates, real estate investment trusts, regulated investment trusts, regulated investment companies, and subchapter S corporations.

The general statutory mechanism for conduits and their owners is to require inclusion of income earned by the entity in the owner's income for the taxable year in (or on) which the entity's taxable year ends.[227] The issue of an owner changing tax status during the year is not addressed in the Code or regulations. With one exception, courts addressing the issue seem to have based their decisions more on grounds of some notion of fairness rather than on a careful consideration of the underlying issues at stake (and sometimes in blatant disregard of statutory language). This is one area that would benefit from legislation.

For instance, assume that a nonresident alien (calendar taxable year) becomes a resident on July 1, and is the sole shareholder of a foreign corporation (calendar taxable year). The corporation earns $500 on June 1, $1000 on August 1, and makes no distributions to its shareholder. The corporation will be a foreign personal holding company from July 1 through the end of the year. Under section 551(b), the shareholder is required to include in income as of December 31, the corporation's undistributed foreign personal holding company income for the year, apparently without regard to whether the income was earned prior to the owner becoming a resident alien.[228]

Marsman v. Commissioner of Internal Revenue[229] addressed the issue of a dual status taxpayer who became a resident alien and was the sole owner of a foreign corporation that had earned sufficient FPHC income

227. *See, e.g.*, I.R.C. § 706(a) (West 1988 & Supp. 1996) (partnership); § 652(c) (West 1988) (simple trust); § 662(c) (West 1988) (complex trust); § 551(b) (West 1988 & Supp. 1996) (foreign personal holding company); § 951(a)(1) (West 1988 & Supp. 1996) (controlled foreign corporation); § 1293(a)(2) (West 1988 & Supp. 1996) (qualified electing passive foreign investment company).

228. The same result would occur if the new resident was a U.S. shareholder of a CFC that was a CFC for the entire year. If the foreign corporation became a CFC for only the portion of the year during which the person was a U.S. resident, the required inclusion would be pro rated. I.R.C. § 951(a)(2)(A). If the foreign corporation were a QEF PFIC, the shareholder would be required to include in income his pro rata share of the QEF's ordinary earnings and net capital gain for the entire year.

229. 205 F.2d 335 (4th Cir. 1953); *aff'g in part and rev'g in part*, Marsman v. Commissioner, 18 T.C. 1 (1952).

to satisfy the FPHC income requirement. Under a literal reading of the statute, the new resident alien had to include in income the entire year's FPHC income. The Fourth Circuit, reversing the Tax Court, rejected a literal reading of the statute and permitted the dual status shareholder to include only the income earned by the FPHC after acquiring U.S. residency. Although the court found that the statutory language was unambiguous, it refused to follow it.

The court's decision is noteworthy as it is based partially on an examination of the policy behind the foreign personal holding company provisions and their application in the context of shareholders changing tax status from source to residence basis taxation. The court found that the purpose of the foreign personal holding provisions was to protect residence basis taxation by taxing currently to U.S. individual shareholders the earnings of certain closely held foreign corporations, which are taxed on a source basis.[230] If, however, the shareholders are not taxed on a residence basis, there is no untoward benefit accruing to them; that is, the U.S. does not care about foreigners who are shareholders of FPHCs because there is no deferral of U.S. income tax.[231]

Although the court's decision reflects sound tax policy, it can be criticized. It is contrary to the explicit and unambiguous language of the statute and may allow taxpayers to pick and choose the treatment more favorable to them. It is also unclear how far the court's rationale that income earned by an entity that would not have been taxable had it been received by the entity's owner prior to becoming a resident should not be taxable when received after becoming a resident. For example, a foreign corporation could eliminate all of its accumulated earnings and profits by distributing a dividend to its foreign shareholder prior to the shareholder becoming a resident alien. Under the rationale of *Marsman*, amounts attributable to such earnings and profits should not be taxable as dividends by the United States if distributed after a nonresident becomes a resident.

In a subsequent case, *Gutierrez v. Commissioner of Internal Revenue*,[232] the Tax Court followed the holding in *Marsman* and found that a new resident alien had to include in income only a ratable portion of the undistributed FHPC income of a FPHC corresponding to the portion of the year the taxpayer was a U.S. resident. It examined the subsequently enacted CFC provisions and how those provisions would apply to a nonresident shareholder of a foreign corporation who becomes a

230. *Id.* at 340.
231. *Id.*
232. 53 T.C. 394 (1969), *aff'd per curiam*, 72-1 U.S.T.C. ¶ 9121 (D.C. Cir. 1971).

resident alien. Specifically, the CFC provisions require a U.S. shareholder of a CFC to include in income his pro rata share of the CFC's subpart F income. The pro rata share of subpart F income is calculated to exclude income attributable to the period during the year that the foreign corporation was not a CFC.[233] The court found that since the purpose of both provisions was similar, they should be interpreted similarly.[234]

The court's rationale is questionable. If Congress intended section 551(b) to operate similarly to section 951(a)(2)(A), why did Congress not amend the FPHC provisions? Also, the section of the CFC provision relied upon does not always give the same and proper answer. For example, assume that two persons, NRA and US, own forty percent and sixty percent respectfully of a foreign corporation for all of 1996 that earns $100 of subpart F income evenly over the year, and that NRA becomes a U.S. resident on July 1, 1996 and remains a resident for the remainder of the year. Because the corporation would be a CFC for the entire year, that is, the fact that NRA became a resident would not affect its status as a CFC, the section relied upon by the court clearly would require NRA to include in income forty percent of the CFC's subpart F income for the entire year—forty dollars—even though had the CFC distributed the fifty dollars of subpart F income earned prior to the NRA becoming a resident alien, the NRA would have had to include only twenty dollars (forty percent of fifty dollars) of CFC's subpart F income.

Marsman provides a strong theoretical approach for treatment of amounts required to be included in income of persons who are changing their tax status: The U.S. should not seek to tax amounts required to be included in income under the CFC, FPHC, and PFIC provisions that have been realized by these entities and are attributable to pre-residency periods. One issue this approach raises is whether the amount to be included under these provisions should be determined on a pro rata basis without regard to when the entity actually earned the income, as was done in *Gutierrez*, or should be included by actually closing the books of the entity on the day prior to the shareholder becoming a resident and examining when the entity earned such amounts, as was done in *Marsman*. The approach of *Marsman* is preferable, because it more accurately reflects the amounts that were earned by the entity prior to the

233. *Guitierrez*, 53 T.C. at 399; I.R.C. § 951(a)(2)(A).
234. *Gutierrez*, 53 T.C. at 399.

shareholder becoming a resident alien, but there may be administrative reasons for the pro rata approach.[235]

The rationale of *Marsman* should be applied only to conduits such as CFCs, FPHCs, and QEF PFICs and not to other corporations. These anti-deferral regimes were enacted to remove the benefit of deferral by taxing U.S. owners currently on certain income realized by the foreign corporation. In essence, the corporate entity is disregarded and the shareholder is treated as realizing the income directly. In the case of CFCs and FPHCs, the rationale for taxing the shareholders is that the U.S. shareholders could have caused the foreign corporation to distribute the earnings; for PFICs, the rationale is that the corporation is merely a passive investment vehicle and therefore the corporation's existence should be disregarded and its earnings taxed directly to the shareholder, as would occur with a domestic passive investment vehicle, such as a RIC. With respect to other corporations that are not conduits, however, their separate existence should be respected, and the tax status of the recipient at the time of distribution should govern.

A more recent case addressing the income of conduit entities earned by a person changing U.S. tax status, *Petschek v. Commissioner of Internal Revenue*,[236] involved a U.S. citizen who renounced his citizenship and was a beneficiary of a simple domestic trust that distributed to the beneficiary after he expatriated income earned prior to expatriation. Although the Code requires the beneficiary of a simple trust to include the amount required to be distributed, it does not specify when such amount is to be included. There were three possibilities: (1) when earned by the trust, (2) ratably, or (3) at year end. The Second Circuit found that the trust beneficiary of a simple trust realized income at the moment the trust receives the income, regardless of when the distribution was actually received.[237]

Both the Tax Court and the Second Circuit rejected the taxpayer's argument that section 652(c) required inclusion at year's end. Under

235. For a discussion of some of the policy issues, see Dale, *supra* note 193, at 312-13; *see also* I.R.C. § 382(b)(3)(A) (West 1988 & Supp. 1996) (requiring pro rata allocation of taxable income for the year between pre-change and post-change date for purposes of determining limitation of losses). The regulations, however, permit taxpayers to elect out of pro rata allocation and instead close the books of the corporation as of the change date. *See, e.g.*, Priv. Ltr. Rul. 9515037 (Jan. 17, 1995). *See also* Treas. Reg. § 1.706-1(c)(2)(ii) (1988) (stating that allocation of section 702(a) items for partner retiring or selling interest in partnership may be done by closing books or by agreement among the partners in taking pro rata part of the amount of such items the partner would have included in taxable income had the partner remained a partner until the end of the partnership year).

236. 738 F.2d 67 (2d Cir. 1984), *aff'g* 81 T.C. 260 (1983).

237. *Id.* at 70.

section 652(c), if the trust's and the beneficiary's tax year differ, the beneficiary includes in income the trust's income for the trust's taxable year ending within the beneficiary's taxable year. This rule clearly posits year-end inclusion for trust beneficiaries, as the income earned by the trust before the end of the beneficiary's taxable year is not included until the following year. Both courts rejected extrapolating from section 652(c) on the grounds that the case did not involve separate taxable years (a weak argument) and that "section 652(c) presupposes the continuation of the beneficiary's and the trust's respective taxpayer statuses from year to year."[238]

It is unclear, however, whether the holding of *Petschek* should be extended to complex trusts.[239] The revenue at stake is potentially much greater in the case of distributions from complex trusts because the distributions may reflect years of accumulations prior to the distribution. The issue is whether the tax status of the beneficiary at the time of distribution or at the time of accumulation should control. There have been no litigated cases or administrative guidance given with respect to this issue. One commentator has indicated that there are structural features of the statutory scheme for complex trust taxation that would support both sides of the issue.[240]

Under regulations section 871-13, the taxability of an item of income is determined by reference to the status of the taxpayer at the time of receipt. Although simple to administer, this approach permits a taxpayer to reduce U.S. taxes by deferring receipt of income earned while a resident until the recipient is a nonresident. In addition, it operates as

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238. *Id.* The tax court at least recognized that section 652(c) "is conceptually at odds with the 'moment of receipt' concept. . .", but stated that it was merely a "legislative rule of convenience limited to different taxable year situations which should not be expanded to cover other cases, such as the one before us, where an analogy would be inexact at best." *Petschek*, 81 T.C. at 270. The regulations interpreting section 652 provide rules covering the death of a beneficiary and eschew the conduit approach of the *Petschek* court. In such case, the beneficiary must include on his last return only income that was actually distributed; other income of the trust required to be distributed is not taxed to the beneficiary but to his estate—a separate taxable entity—under section 691. Treas. Reg. § 1.652(c)-2 (1960). This regulation was upheld in Schimberg v. U.S., 365 F.2d 70 (7th Cir. 1966).

239. A complex trust is a trust that is not a simple trust. Estates are taxed in the same manner as complex trusts. A trust that is not required to currently distribute all of its accounting income is a complex trust, and so is a trust that distributes or is required to distribute amounts other than accounting income.

240. Dale, *supra* note 193, at 317-22.

a tax on the unwary in the case of a resident alien who receives an item of income attributable to a period during which he was a nonresident alien. The approach of sections 864(c)(6) and (7), which tie the taxability of an item of income not to time of receipt but rather to when it was economically earned, is conceptually superior, and should be adopted as a guiding principle in formulating rules for persons changing tax status.

E. Gains and Losses

Another important issue that arises when persons or property change tax status is how to determine gain or loss on the disposition of property that was acquired, perhaps with foreign currency, and when the person or property was not subject to residence or trade or business basis taxation. Because changing U.S. tax status has no effect for U.S. tax purposes in determining the gain or loss realized on the sale of property subject to U.S. tax, the property's tax history must be recreated under U.S. tax principles using U.S. dollars.[241] Although it is possible to recreate the basis of property in simple cases, there is no guidance on how to take into account, for example, elections to deduct or capitalize certain expenses. Furthermore, recent regulations dealing with foreign currency transactions can be read to support the position that recreation is not necessary, and instead certain property may receive a basis equal to its fair market value immediately prior to becoming subject to residence basis taxation. These two results are contradictory and cannot reflect a coherent policy. The next section will first address the basis issues that arise with respect to nondepreciable property, and will then address some further complications that arise with respect to depreciable property.

1. Determining the Basis of Nondepreciable Property That Becomes Subject to U.S. Tax

a. General

Gain or loss is calculated by comparing the amount realized on the sale or other disposition of property with the property's adjusted

241. Heckett v. Commissioner, 8 T.C. 841 (1947); Abraham v. Commissioner, 9 T.C. 222 (1947); Reisner v. Commissioner, 34 T.C. 1122 (1960); Gutwirth v. Commissioner, 40 T.C. 666 (1963); Rev. Rul. 56-514, 1956-2 C.B. 499; Gen. Couns. Mem. 34572 (Aug. 3, 1971).

basis.[242] The adjusted basis of property is generally its cost, adjusted for capital improvements and depreciation.[243] Because the amount realized will generally be readily determinable, gain or loss will be known once the property's cost basis is determined.[244] Section 1012 provides that the property's basis is generally its cost. If property has been purchased in foreign currency—as is likely in the case of a nonresident—and the value of the currency vis-a-vis the dollar has changed since the acquisition date, the issue becomes how to calculate the original cost basis.

Since 1986, the Code has contained detailed rules regarding the consequences of dealings in foreign currency.[245] At the heart of these rules is the concept of functional currency. Section 985(a) requires that all determinations under the Code be made in the taxpayer's functional currency. For individuals, the functional currency is the dollar.[246] Since neither the Code nor the regulations specifically provide otherwise, individuals becoming U.S. residents must also use the dollar as their functional currency. Consequently, upon becoming subject to residence basis taxation and the occurrence of a taxable event, for example, a sale or exchange of property, a resident alien disregards her dealings in foreign currency and makes all determinations of gain or loss in U.S. dollars. For property acquired before U.S. residency, its cost basis will therefore be its historical dollar cost,[247] and gain or loss is computed by comparing the amount realized with the historical dollar cost. This can produce surprising results. Depending on the variation in the dollar/foreign currency exchange rate, a resident alien selling property acquired with foreign currency and while a nonresident alien may recognize gain even though the foreign currency value of the property remained the same or declined.

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242. I.R.C. § 1001(a) (West 1988 & Supp. 1996).
243. I.R.C. §§ 1011(a), 1012, 1016 (West 1988 & Supp. 1996).
244. In the case of installment sales, questions may arises with respect to the timing of the gain or loss. *See* I.R.C. § 453 (West 1988 & Supp. 1996); S. REP. NO. 96-1000, at 12 (1980), *reprinted in* 1980-2 C.B. 494.
245. I.R.C. §§ 985-989 (West 1988 & Supp. 1996).
246. Treas. Reg. § 1.985-1(b)(1) (1994).
247. The foreign exchange rate used to translate the foreign currency into U.S. dollars is the spot rate, which is defined in temporary regulations section 1.988-1(d)(1) as being the fair market rate of exchange available to the public for currency under a spot contract in a free market and involving representative amounts. Temp. Treas. Reg. § 1.988(d)(1) (1992).

For example, assume that Juana, a nonresident, purchases a share of stock for 1000 pesetas when the value of one peseta is ten cents, becomes a U.S. resident and the day after becoming a resident, sells the stock for 1000 pesetas when the value of the peseta is twenty cents. Because a resident must use the dollar as her functional currency, she will have gain of $100, even though the value of the stock in pesetas did not change. Conversely, if the peseta had depreciated against the dollar (reversing the above values), the taxpayer would realize a loss of $100 upon sale of the stock.

A nonresident contemplating becoming a resident alien can, however, easily eliminate the U.S. tax on the gain, including currency gain, accruing prior to U.S. residency by selling the appreciated property and immediately repurchasing it for its fair market value. Thus, U.S. taxation of pre-residency gain occurs only in instances where a nonresident alien is ill-advised or holds property that cannot easily be sold and repurchased.

b. *Taxpayers With Qualified Business Units*

Further complications can arise in the case of a new resident with a qualified business unit ("QBU"). A QBU is any "separate and clearly identified unit of trade or business of a taxpayer provided that separate books and records are maintained."[248] Certain QBUs must use the dollar as their functional currency, for example, a QBU that conducts its activities primarily in dollars.[249] QBUs that are not required to use the

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248. Treas. Reg. § 1.989(a)-1(b)(1) (1990). Although a person is not a QBU, a corporation is a QBU as well as a partnership, trust, or estate of a partner or beneficiary. The activities of a trust, estate, or individual qualify as a QBU if the activities constitute a trade or business and a separate set of books and records is maintained with respect to the activities. Treas. Reg. § 1.989(a)-1(b)(2). Although the existence of a trade or business is a question of fact, the regulations state that "a trade or business for purposes of section 989(a) is a specific unified group of activities that constitutes (or could constitute) an independent economic enterprise carried on for profit, the expenses related to which are deductible under section 162 or 212." Treas. Reg. § 1.989(a)-1(c), (e) (maintenance of portfolio of securities with foreign broker is a QBU because investment activities constitute a QBU).

249. Treas. Reg. § 1.985-1(b)(2) (1994). Other QBUs that must use the dollar as their functional currency include QBUs with a U.S. residence, a QBU that does not keep books and records in the currency of any economic environment in which a significant part of its activities is conducted, or any activity that produces income or loss that is effectively connected with a U.S. trade or business. Treas. Reg. § 1.985-1(b)(1)-(6). Also, since 1994, QBUs that could have used a hyperinflationary currency as their functional currency are required to adopt the dollar as their functional currency. These rules may not be valid. *See* Jeffrey Colon & Alan Fischl, *IRS Proposes Major Changes to Dollar Approximate Separate Transaction Method Regulations*, 21 TAX MGMT. INT'L J. 151 (1992).

dollar as their functional currency must use as their functional currency the currency of the economic environment in which a significant part of the QBU's activities are conducted.[250]

Assume that Juana becomes a U.S. resident and she has a QBU that, as a result of her new residence, is now required to use the dollar as its functional currency. This could occur in the case of a business that conducts its activities primarily in dollars.[251] Although the regulations do not specifically address the consequences of a change in functional currency of a QBU that is caused primarily by a change in the owner's tax residence, it appears that use of the dollar by the QBU as its functional currency would be considered to be either an adoption or change in the QBU's functional currency.[252] A QBU changing functional currency is required to restate the adjusted bases of its assets in its new functional currency. Specifically, the dollar adjusted bases of the QBU's assets will be the old functional currency adjusted bases multiplied by the dollar/old functional currency spot exchange rate on the last day of the taxable year ending before the year of change.[253] The adjustment mandated by the regulations eliminates any foreign currency gain or loss accruing prior to the year of change of residence. Thus, continuing with the preceding example, and assuming that the spot rate at the end of the year preceding the year of change of status is 1 peseta is equal to twenty cents, the dollar basis of the stock would become $200, and upon a sale of the stock for $200, the new resident would not recognize any gain or loss.

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250. Treas. Reg. § 1.985-1(c)(1).
251. Treas. Reg. § 1.985-1(b)(1)(ii).
252. The regulations sweepingly state: "Regardless of any change in circumstances, a QBU may change its functional currency determined under [regulation section 1.988-1-(c)] only if the QBU complies with §1.985-4 . . . ." Treas. Reg. § 1.985-1(c)(6) (1994). This rule also applies to QBUs with dollar functional currencies. Although far from certain, this language could be interpreted to mean that a change in a QBU's functional currency would not be considered an adoption of the dollar as a functional currency but a change in functional currency. As one commentator has pointed out, "[t]he significance of an adoption of the U.S. dollar as the owner's functional currency in this context. . .is not addressed in the statute or regulations." Mary F. Voce, *Basis of Foreign Property that Become Subject to U.S. Taxation*, 49 TAX LAW. 341, 378 (1996).
253. Treas. Reg. § 1.985-5(c) (1993). One commentator has noted that the regulations require certain taxpayers to use the U.S. dollar as their functional currency, but also that any change of functional currency requires the Commissioner's approval. In the case of a QBU that had not previously used the dollar as its functional currency, it appears that the Commissioner's permission would be required. *See* Voce, *supra* note 252, at 379 n.152.

Assuming that this is a proper interpretation of the regulations, the results vary for the new resident alien depending on whether the property does or does not constitute a QBU, a purely formal distinction that should not produce different tax consequences.[254] Furthermore, it may permit taxpayers changing tax status to pick between these two options, depending on which is more favorable.[255] There does not seem to be any policy rationale for the different results, and they appear to result from oversight rather than a conscious policy decision.[256]

Additional foreign currency translation issues arise if the resident alien has a QBU that does not need to adopt the dollar as its functional currency, denominated in the parlance of the regulations as a "QBU branch."[257] In such case, the QBU branch must use the profit and loss method of accounting under which the QBU branch's income or loss is first determined in the QBU's functional currency (adjusted to conform to U.S. tax principles) and then translated into the taxpayer's functional currency, generally the U.S. dollar, at the weighted average exchange rate for the taxable year.[258]

Under the profit and loss method, any exchange gain or loss in the QBU's undistributed earnings or capital as a result of changes in the dollar/QBU functional currency exchange rate, called "section 987 gain or loss," is not recognized until the branch makes a remittance to the taxpayer.[259] More specifically, the section 987 gain or loss is computed by establishing two pools, an equity pool and a basis pool. For QBU branches operated after 1987, the opening balance of the equity pool equals the adjusted basis of the QBU branch's assets, less the amount of the QBU branch's liabilities on the date the QBU branch first uses the

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254. Some commentators have suggested that regulation section 1.985-5 was not drafted with the dollar election in mind because literal application of the regulations can cause unrealized currency gain or loss to disappear. *See* Clifford E. Muller & G. Garner Prillaman, Jr., *Tax Aspects of Foreign Currency*, 921 TAX MGMT. (BNA) A-19 (1991) They also point out that this result is inconsistent with the result obtained for QBUs operating in a hyperinflationary environment that are required to adopt the dollar as their functional currency. In such cases, the *historical* rather than *spot* exchange rates are used to convert the adjusted bases of the QBU's assets to the dollar. *See* Prop. Treas. Reg. § 1.985-7(a), 58 Fed. Reg. 300 (1993); Treas. Reg. § 1.985-6(c) (1993).

255. For instance, if the taxpayer can demonstrate that a substantial nontax purpose exists for not keeping its books and records in the "economic environment" currency, it may fail the books and record requirement of section 985(b)(1)(B) and accordingly be defaulted into using the dollar as its functional currency. Treas. Reg. § 985(b)(1)(B) (1993).

256. *See also* Voce, *supra* note 252, at 379 (arguing that approach of section 1016, which uses an historical dollar basis, is inconsistent with foreign currency rules of regulations section 1.985-5(c)).

257. Prop. Treas. Reg. § 1.987-1(a)(2), 56 Fed. Reg. 48457 (1991).

258. *Id.*

259. *Id.*

profit and loss method of accounting.[260] The basis pool equals the opening balance of the QBU branch's equity pool translated into the taxpayer's functional currency at the spot rate on the date the QBU branch first uses a profit and loss method of accounting.[261]

Assuming that QBU first begins to use the profit and loss method of accounting when the alien becomes a U.S. resident, since the basis pool will be equal to the equity pool times the spot rate, any pre-residency currency gain or loss will be eliminated. Continuing with the above example, if the stock purchased by Juana alien for 1000 pesetas when the peseta/dollar exchange rate was one peseta to ten cents and is remitted to her the day after she becomes a resident when the peseta/dollar exchange rate is one peseta to twenty cents, the property will take a basis of $200.[262] Thus, no exchange gain or loss will be recognized upon the remittance of the property to the taxpayer, even though the dollar has appreciated against the peseta since the date of purchase.

The tax consequences in this scenario are conceptually inconsistent with the tax consequences had the property of the resident alien not constituted a QBU. Again, there does not seem to be any policy rationale for the different results.

2. *Determining the Basis of Depreciable Property That Becomes Subject to U.S. Tax*

Additional complications arise when the property brought into U.S. tax jurisdiction is depreciable.[263] One issue is how to determine the depreciation adjustments that should be made for the period during which the taxpayer and the income from the property were not subject to U.S. taxation.[264] A second related issue is what account, if any, should be made for depreciation that was taken when the property and

260. *Id.*
261. *Id.*
262. *Id.*
263. For a detailed examination of the historical development of section 1016 and the issues involving foreign property that becomes subject to U.S. tax, see Voce, *supra* note 252, at 345-74.
264. These issues can arise not only in the case of a nonresident becoming a resident, but also when an entity that owns property and that is not subject to taxation, for instance, a tax-exempt entity, becomes subject to income taxation, or when property that is owned by a foreign corporation begins to be used in a U.S. trade or business.

taxpayer were subject to U.S. taxation but was disposed of when the taxpayer and property were not subject to U.S. taxation.

It is uncontrovertible that the original cost basis of depreciable property[265] that is brought into U.S. tax jurisdiction (either because its owner becomes a resident alien or it is used in a U.S. trade or business by a foreign person) must be adjusted for depreciation even for the period during which the income, gain, or loss from the property would not be subject to U.S. taxation.[266] The unresolved issue is whether the depreciation adjustment should be made pursuant to section 1016(a)(3) or section 1016(a)(2).

Section 1016(a)(3) was enacted in 1954 to specifically address the issue of depreciation adjustments for property held by tax-exempt entities that become subject to taxation. The legislative history to the provision notes that Congress specifically rejected both a fair market value basis and an original cost basis at the time the organization became subject to tax, and instead, following the position of the Service, required that the cost basis be adjusted for depreciation "sustained" during the period the tax-exempt entity was not subject to income tax.[267] If section 1016(a)(3) applies, the regulations require the basis to be adjusted in one of two ways: The taxpayer can use the method used on his books, provided the amount is reasonable. If not, the taxpayer must compute depreciation using the straight-line method and treating the property as if it had been always subject to income tax.[268]

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265. Depreciable property is property that is used in a trade or business or for the production of income.

266. Gutwirth v. Commissioner, 40 T.C. 666 (1963); Abraham v. Commissioner, 9 T.C. 222 (1947); Schnur v. Commissioner, 10 T.C. 208 (1948); Tech Adv. Mem. 87-49008 (Aug. 18, 1987); and Gen. Couns. Mem. 39,291 (Sept. 24, 1984).

267. Voce, *supra* note 252, at 355 (citing S. REP. NO. 1622, 83d Cong., at 108 (1954)). Although the provision was clearly intended to apply to domestic tax-exempt entities that became subject to U.S. income taxation, probably as a result of the enactment of the unrelated business income provisions in 1950, the issue is conceptually analogous to that which arises when either foreign persons who become subject to U.S. income tax own property used in a trade or business or property begins to be used in a U.S. trade or business. Furthermore, section 168(h)(2)(iii), added in 1986, defines tax-exempt entity for purposes of section 168 to include not only domestic tax-exempt entities but also "any foreign person or entity." I.R.C. § 168(h)(2)(iii) (West 1988 & Supp. 1996).

268. Treas. Reg. § 1.1016-4(b) (as amended in 1963). For a discussion of how these measures have been applied by the IRS and the courts, see Voce, *supra* note 252, at 356-62. It is surprising that the regulations give priority to the method used for foreign law purposes. The Service has consistently argued that a taxpayer must apply U.S. legal principles to determine U.S. tax liability, and the courts have strongly supported the IRS. *See, e.g.*, United States v. Goodyear Tire & Rubber Co., 110 S. Ct. 462 (1989). One issue that is unclear is how the straight-line method is to be applied. As one commentator has pointed out, when the regulation was enacted, an asset was depreciated over its useful life, which corresponded to its economic life. Voce, *supra*

Under section 1016(a)(2), the property's basis for any post-February 28, 1913 period must be adjusted by the "exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount allowed as deductions in computing taxable income." For the period that a taxpayer is not subject to U.S. income tax, there is strong support for the argument that no depreciation was "allowed" and that section 1016(a)(2) is, therefore, inapplicable.[269] The Service, however, has applied section 1016(a)(2), and the regulations thereunder, to property brought into U.S. tax jurisdiction after it had previously been used abroad.[270] Under this approach, the prior depreciation adjustment is based on the depreciation method selected by the taxpayer for the first period the taxpayer is subject to U.S. taxation.[271] The adjusted basis determined under section 1016(a)(2) will in most cases result in the property having a lower basis than it would under section 1016(a)(3), if the straight-line method is used.

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note 252, at 371. Under the current depreciation system of section 168, a taxpayer can elect to depreciate an asset by the straight-line method, but the recovery periods are set out in the statute and are intended to be generally shorter than the economic life of the asset. *See* I.R.C. §§ 168(b)(5) (straight-line election) and 168(c) (1996) (recovery periods). If the property is used predominantly outside the United States or is leased to a tax-exempt entity, including a foreign person or entity, depreciation is calculated using the straight-line method with statutorily prescribed recovery period of the asset's class life, which is generally longer than the asset's recovery period for property used in the United States. I.R.C. § 168(g).

269. *See* Voce, *supra* note 252, at 348-49 and authorities cited therein.

270. Tech. Adv. Mem. 87-49008 (Aug. 18, 1987). The basis for the T.A.M.'s conclusion was regulations section 1.1016-3(a)(2), which provides that if a taxpayer takes a deduction for depreciation properly under one of the methods provided in section 167(b) for one or more years but has omitted the deduction in other years, the adjustment to basis for the depreciation allowable will be the deduction under the method used by the taxpayer with respect to that property. As one commentator has pointed out, the applicability of this regulation is doubtful because it was clearly intended to apply to situations "where the taxpayer has properly taken a depreciation deduction for U.S. tax purposes for a year prior to the year involved. . ." Voce, *supra* note 252, at 360. Thus, it would apply to a resident alien who became a nonresident alien and then subsequently became a resident alien. In Gen. Couns. Mem. 39,291 (Sept. 24, 1984), which involved nearly identical facts as the above cited T.A.M., the Service appeared to require the taxpayer to adjust the basis of the property using an approach that combined aspects of both section 1016(a)(2) and section 1016(a)(3). For a discussion, see Voce, *supra* note 252, at 371.

271. Treas. Reg. § 1.1016-3(a)(2) (1960).

3. *Owners of PFICs That Change U.S. Tax Status*

In sections 864(c)(6) and (7), Congress addressed the tax issues raised by persons and property leaving U.S. tax jurisdiction. The Service recently confronted this issue in the proposed PFIC regulations.[272] Enacted in 1986, the PFIC provisions were designed to equalize the taxation of U.S. shareholders of foreign investment funds with that of U.S. shareholders of domestic investment funds.[273] The PFIC provisions limit the potential of a U.S. shareholder to achieve tax deferral of the earnings of a foreign corporation by either currently taxing the earnings of a PFIC (in the case of a qualified electing fund, "QEF") or imposing an interest charge on distributions from a PFIC (in the case of a "section 1291 fund").[274]

The proposed regulations provide that if a shareholder of a section 1291 fund changes U.S. residence or citizenship, such change is treated as a disposition of the stock of the section 1291 fund on the last day that the shareholder is a U.S. person.[275] This rule does not apply, however, to shareholders of pedigreed QEFs. This rule is necessary in order to prevent persons changing U.S. tax status from avoiding the PFIC provisions. In the absence of this rule, a shareholder of a PFIC

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272. 57 Fed. Reg. 11,024 (1992). The Service had previously confronted the issue. In Rev. Rul. 74-351, 1974-2 C.B. 144, the Service ruled that a taxpayer who makes the proper election does not have to include in income any "deferred income," which is income not readily convertible into U.S. dollars. Income will not constitute deferred income, however, if it is disposed of by gift, bequest, or in the case of an election by a resident alien, if U.S. residency is terminated. The rationale for this treatment is not explicit, but perhaps is based on the assumption that the alien will return to his country and be able to use the funds. If so, it is not consistent with the part of the ruling allowing the taxpayer to purchase property with the blocked income without triggering gain. *See* Berman v. Commissioner, 45 T.C. Memo. 1983-214 (1983) (upholding, in dicta, the position of the Service).

273. The PFIC provisions have been subject to criticism. *See* H. Stewart Dunn, *PFIC Rules-Tax Policy Gone Awry*, 39 TAX NOTES 625 (1988).

274. The interest charge regime applies to "section 1291 funds," which consist of "unpedigreed QEFs" or "nonqualified funds." Prop. Treas. Reg. § 1.1291-1(b)(2)(v), 57 Fed. Reg. 11,024 (1992). An unpedigreed QEF is a PFIC for which a QEF election under section 1295 has been made for one but not all of the years included in the shareholder's holding period and during which the corporation was a PFIC. Prop. Treas. Reg. § 1.1291-1(b)(2)(ii), 57 Fed. Reg. 11,024 (1992). A nonqualified fund is a PFIC with respect to which a shareholder has not elected under section 1295 to treat as a QEF. Prop. Treas. Reg. § 1.1291-1(b)(2)(iv), 57 Fed. Reg. 11,024 (1992).

275. Prop. Treas. Reg. § 1.1291-3(a)(2), 57 Fed. Reg. 11,024 (1992). The regulations also provide that a termination of an election under section 6013(g) is treated as a change of residence of the spouse who was a resident solely by reason of the section 6013(g) election. *Id.* Section 6103(g) permits a nonresident alien to join in the filing of joint tax return with a U.S. resident or citizen, but at the cost of being subject to residence basis taxation. I.R.C. § 6013(g) (West 1989 & Supp. 1996).

switching from residence to source basis taxation could avoid the PFIC provisions by merely not making the QEF election, not receiving any distributions from, or not disposing of, PFIC stock prior to leaving residence basis tax jurisdiction.[276] In the case of a pedigreed QEF, because a resident U.S. shareholder will have been taxed on all of the earnings of the PFIC while a U.S. person, there has been no deferral of the earnings of the PFIC for the time during which the U.S. shareholder has been subject to residence basis taxation, and thus, there is no need to collect any further tax upon a change of tax residence.

Residence basis taxation is further protected by provisions in the proposed regulations limiting the potential to transfer tax free stock of a section 1291 fund out of U.S. tax jurisdiction. For example, the transfer by gift to a non-U.S. person is treated as a disposition.[277] In addition, if a shareholder dies owning stock of a PFIC, gain is recognized on the transfer to a domestic estate if the estate has a foreign beneficiary or establishes a trust to which the stock of the section 1291 fund may be transferred under terms of the will.[278] Furthermore, U.S. beneficiaries do not get a free ride. Unless all gain is required to be recognized—because the shareholder's domestic estate has a foreign beneficiary or establishes a trust to which the stock of the PFIC may be transferred—the basis of stock received on the death of the decedent by the decedent's estate (other than a foreign estate) or by another U.S. person is the lower of the fair market value or adjusted basis of the stock in the hands of the shareholder immediately before death.[279]

Many commentators have questioned the validity of the proposed regulations which treat a change in tax status as a realization event.[280] The relevant portions of the proposed regulations regarding dispositions

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276. Because a U.S. person that is a shareholder of a PFIC is subject to the PFIC regime regardless of the percentage of ownership, it is possible that the U.S. person could not actually control distributions from the PFIC. On the other hand, these types of funds are generally marketed to persons with the understanding that the fund managers will not make distributions of the fund's earnings. The shareholder can indirectly obtain the earnings of the fund, however, by selling shares of the fund.

277. Prop. Treas. Reg. § 1.1291-6(a)(2), (b), 57 Fed. Reg. 11,024 (1992).

278. Prop. Treas. Reg. § 1.1291-6(c)(2)(iii)(A)-(B), 57 Fed. Reg. 11,024 (1992).

279. Prop. Treas. Reg. § 1.1291-6(b)(4)(iii), 57 Fed. Reg. 11,024 (1992).

280. *See, e.g.*, ISENBERGH, *supra* note 69, ¶44.10 at 44:9 (stating that expatriation of U.S. person is not a transfer within meaning of section 1291(f)); *see also* Letter to IRS from Haas and Mogenson (May 18, 1992), *available in* LEXIS, Fedtax Library, TNT File, 92 TNT 116040; Letter from J. Schmitz of H.B. Fuller Co. to IRS (July 30, 1992), *available in* LEXIS, Fedtax Library, TNT File, 92 TNT 165-81.

interpret section 1291(f), which requires the recognition of gain notwithstanding any provision of law in the case of any "transfer of stock of a PFIC." It is highly questionable whether a "transfer" includes changes in U.S. tax status, especially since it has not been so interpreted by Congress or the courts.[281] In addition, there is no indication in the legislative history that Congress intended a change in tax status to be considered a disposition or transfer of PFIC stock.[282] On the other hand, section 1297(f) grants the Treasury the power to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of this part." This grant of legislative regulatory authority is quite broad, and unless the regulations are arbitrary, capricious or contrary to the statute, they may likely be upheld.[283]

Other issues can arise when a person changes U.S. tax status and owns stock of a PFIC. One issue is the effect of making a purging election under section 1291(d)(2) for the year of change of status.[284] Assume that a calendar year nonresident alien owns appreciated shares of a foreign corporation that is a PFIC, becomes a resident alien on July 1, 1996, and makes a QEF election with respect to the foreign corporation for the taxable year 1996. Under section 1291(d)(2), a taxpayer electing to treat a PFIC as a QEF that holds stock "in such company" on the first day of the taxable year, and establishes its fair market value on that date, can elect "to recognize gain as if [the taxpayer] sold such stock on such first day for such fair market value." It would appear that a new

281. *See* Isenbergh, *supra* note 69, ¶ 44.10 at 44:9 (citing Rev. Rul. 76-339, 1976-2 C.B. 251, which states that removal of property from U.S. tax jurisdiction is not a disposition of property for purposes of section 1245).

282. In the Omnibus Budget Reconciliation Act of 1992 ("OBRA '92"), Congress passed legislation simplifying the anti-deferral regimes by creating a new statutory creature, the Passive Foreign Corporation. OBRA '92 was vetoed by then President Bush, and to date, the provisions have not become law. In the legislative history to OBRA '92, the House Report stated that the Service has the authority to issue regulations dealing with changes in residency. In a blatant attempt to strengthen the Service's hand with respect to the proposed PFIC regulations, the report stated that "[n]o inference be drawn from this explicit regulatory authority as to the Secretary's authority to issue similar regulations under the authority of the PFIC provisions of present law." H.R. REP. NO. 631, 102d Cong., at 184 (1992).

283. *See* Tate & Lyle Inc. v. Commissioner, 87 F.3d 99 (3d Cir. 1996), *rev'g* 103 T.C. 656 (1994). For a discussion of the current trends in interpreting tax regulations, see Ellen P. Aprill, *Muffled Chevron: Judicial Review of Tax Regulations*, 3 FLA. TAX REV. 1 No. 2 (1996).

284. If a taxpayer makes a QEF election and the foreign corporation has been a section 1291 fund for part or all of the taxpayer's holding period, the taxpayer can elect to purge the section 1291 fund taint by marking to market the stock as of the first day of the taxable year. The taxpayer must recognize any gain, and such gain will be subject to the deferred tax regime of section 1291. Henceforth, the stock will be treated as a pedigreed QEF.

resident alien shareholder of a PFIC could obtain a fair market value basis for the PFIC as of the first of the year, when he was not a U.S. resident.[285]

A more intriguing issue arises if the new resident alien owns shares of a PFIC that is also a CFC and for which a QEF election is made. Under section 1291(d)(2)(B), a shareholder of QEF-electing PFIC that is also a CFC may elect to include in income, as a dividend, the post-1986 earnings and profits of the company on the first day of the taxable year for which the QEF election is made. Thus, under section 1291(d)(2), not only may it be possible to step up the basis of the shares of a PFIC to their fair market value as of the first day of the first year in which a person becomes a resident alien and eliminate the corporation's post-1986 earnings and profits, but it may also be possible to increase further the basis of the shares by the amount of the deemed dividend, which is deemed to be recontributed to the corporation.[286]

4. *Losses*

Under section 1001(c), upon the occurrence of a realization event, any gain or loss must be recognized, unless a nonrecognition provision applies. For individuals, however, the recognition of loss is limited, by section 165(c), to losses incurred in a trade or business, for-profit transaction, or casualty. If the loss is capital, it is further limited under sections 1211 and 1212. For securities that are capital assets and

285. One commentator has addressed this issue but assumes that the election is made when the person was a nonresident alien, and therefore seems to miss the point that the election could be made while the taxpayer was a resident alien but have consequences for the pre-residency period because the deemed sale occurs at the beginning of the taxable year. *See* Isenbergh, *supra* note 69, ¶ 44.25 at 44:28-44:29. The year of change of tax status does not end the taxable year but merely bifurcates it into a period of residence and nonresidence (or citizenship and nonresidence).

Because a foreign corporation is not treated as a PFIC for any period in the shareholder's holding period before the shareholder became a U.S. person, it is possible that the election under section 1291(d)(2)(A) may not be available. Prop. Treas. Reg. § 1.1291-1(b)(1), 57 Fed. Reg. 11024 (1992). This result could be arrived at by the language in section 1291(d)(2)(A)(ii), which requires that the electing taxpayer hold stock in "such company" on the first day of the taxable year. It may be possible to interpret "such company" as requiring that the company be a PFIC at the first day of the taxable year. If so, the election may be denied the new resident alien on the grounds that the company was not a PFIC on the first day of the taxable year with respect to the taxpayer. Such interpretation, however, would be quite a stretch, even for the Service.

286. I.R.C. § 1291(d)(2)(C) (West 1988 & Supp. 1996).

become worthless during the taxable year, section 165(g)(1) provides that the loss shall "be treated a loss from the sale or exchange, *on the last day of the taxable year*."[287] Special rules applicable to straddles and wash sales may also limit the recognition of losses.[288]

Losses "must be evidenced by closed and completed transactions."[289] An arm's length sale or exchange of property is generally sufficient to satisfy the closed and completed transaction requirement. Accordingly, the advice given to dual status taxpayers is to avoid realizing gains but to realize losses while subject to residence basis taxation.[290]

For a dual status taxpayer, the crucial issue is whether the loss, for purposes of section 165, has occurred prior to immigration. In Revenue Ruling 80-17,[291] a new resident alien, RA, had left behind property in country X, consisting of personal service business and stock of a foreign corporation. RA had left X pursuant to a limited exit visa, and the laws of X provided that any citizen who had not returned to X at the expiration of the visa would have his property nationalized. Upon the expiration of RA's exit visa, X expropriated his property, and for the taxable year in question, RA claimed a loss for the expropriated assets. The Service ruled that RA was not entitled to the loss under section 165(c)(1) or (2). It found that since RA did not intend to return to X, RA's "enjoyment of ownership rights in the property terminated . . . at the time A departed from X. Therefore, the loss of A's property occurred before A became a United States resident alien."[292]

287. I.R.C. § 165(g)(1) (West 1988 & Supp. 1996) (emphasis added).

288. I.R.C. §§ 1091, 1092 (West 1988 & Supp. 1996).

289. Treas. Reg. § 1.165-1(b) (as amended in 1977).

290. *See, e.g.*, Monte A. Jackel, *Aliens: Becoming a U.S. Resident After the '84 Act*, 45 INST. ON FED. TAX'N, § 45.13[1] at 45-70. This statement, of course, begs the question of whether a loss is realized, and to determine that, the property's adjusted basis must be known.

291. Rev. Rul. 80-17, 1980-1 C.B. 46.

292. *Id.* More problematical, the Service also ruled that even if the loss occurred after RA became a resident, it would not be allowed. The ruling stated that a necessary condition to the allowance of losses under section 165(c)(1) and (2) is that any income from the property would have been taxable. The Service stated that in order to receive income or otherwise enjoy the property, RA would have had to return to X, thereby abandoning his U.S. residency. This conclusion is questionable. Even though A could not have received or otherwise enjoy income from the property, he nevertheless would have been taxed on the income, unless a blocked income election were made. Furthermore, after 1984, RA's return to X would not have necessarily terminated his U.S. residency, and consequently, he would have still been subject to U.S. taxation. *See also* Gen. Couns. Mem. 33,922 (Aug. 30, 1968); Gen. Couns. Mem. 37,881 (Mar. 14, 1979) (detailing the legal analysis of Rev. Rul. 80-17). This position has been rejected by the courts. *See* Makouipour v. Commissioner, 55 T.C. Mem. (CCH) 1516 (1988) (finding no support for claim that section 165(c)(1) requires that income from expropriated property be subject to U.S. income tax as prerequisite to the deductibility of an expropriation loss); Bello v. Commissioner, 33 T.C. Mem. (CCH) 747 (1974); *see*

Provided that the loss occurs, for tax purposes, after a person has become a resident alien, it will be recognized for U.S. tax purposes, even though the decline in value occurred prior to U.S. residency. This treatment is surprising. In the analogous situation of a conversion of a personal residence into income producing property, the losses that economically accrue prior to conversion are disallowed.[293] The rule prevents taxpayers from converting losses that economically accrued during a period in which they could not have been deducted had the property been sold into deductible losses merely by converting the property into income producing property and selling the property. This issue is analogous to that arising when nonresidents become residents and own property with built-in losses. In essence, by becoming a resident alien, the taxpayer has converted losses that, if realized prior to U.S. residency, would not have reduced U.S. income tax into losses that, when realized, can reduce U.S. income tax.

F. Summary

Over the last sixty years, Congress has neglected to address the tax issues that arise for persons or property entering U.S. residence (or trade or business) tax jurisdiction. Since changing tax status has not been treated as a taxable event, except in the proposed PFIC regulations, the status of the taxpayer at the time of receipt controls in computing taxable income. Consequently, well-advised taxpayers can reduce U.S. income by accelerating income or deferring deductions until they are subject to residence basis taxation. There are still uncertainties regarding taxable years and accounting methods, which make it difficult to determine U.S. tax consequences. In computing gain or loss, a new U.S. taxpayer must recreate the tax history of his property acquired prior to becoming a U.S. resident. Pre-residency gain may, therefore, be subject to U.S. tax and pre-residency losses may offset U.S. tax. Again, the well-advised taxpayer can avoid these results by simply selling property with built-in

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also Ribas v. Commissioner, 54 T.C. 1347 (1970); Bibiloni v. Commissioner, 32 T.C. Mem. (CCH) 1369 (1973).

293. More specifically, when a U.S. person converts a personal residence into income producing property, the property's adjusted basis for purposes of determining loss and depreciation is the lower of the fair market value of the property at the time of conversion or the property's adjusted basis under section 1011. Treas. Reg. §§ 1.165-9(b)(2), 1.167(g)-1 (as amended in 1964); *see* Heiner v. Tindle, 276 U.S. 582 (1928).

gains prior to becoming a resident and waiting to realize losses until after becoming a resident. However, regulations under both the foreign currency and PFIC rules may allow a taxpayer to achieve a step up in basis in certain property. These results are probably unintended.

To avoid this tax trap on the unwary and prevent taxpayers from selectively realizing losses but avoiding tax on gains, the U.S. should require that for persons changing tax status, (or for property the income or gain from which becomes subject to U.S. taxation) the property held by them, at the time of immigration, should be marked to market. As discussed above with respect to expatriates, a mark-to-market regime for immigrants would also increase fairness by treating similarly situated taxpayers equally. It would also increase economic efficiency by reducing the lock-in effect for assets with built-in gain held prior to immigration. It would be easier to administer than the current regime and, finally, would be consistent with the principles of sections 864(c)(6) and (7).

VII. FURTHER THOUGHTS ON ACCRUAL BASIS TAXATION

A. Expatriation and U.S. Wealth Transfer Taxes

Some commentators have argued that the real impetus driving wealthy persons to expatriate is to avoid U.S. wealth transfer taxes rather than U.S. income taxes.[294] Indeed, it was suggested that a mark-to-market regime may actually induce more persons to expatriate, especially those who had recently inherited substantial bequests or recently sold valuable businesses.[295] As pointed out by other commentators, however, an accrual basis regime would not induce a person with high basis assets to expatriate in order to avoid U.S. wealth transfer taxes any more than the current expatriate transfer tax provisions.[296] During discussion of the expatriate provisions, it is surprising that very little attention was focused on the transfer tax issue, even though it is recognized that upon

294. *See* Lee A. Sheppard, *Defining the Expatriate Tax Debate*, June 13, 1995, available in LEXIS, Fedtax Library, TNT File, 95 TNT 114-5; Gene Steuerle, *Alternatives to the Expatriate Tax*, 67 TAX NOTES 567 (1995); JCT Report 3, *supra* note 9, at 4 ("[C]ertain anecdotal evidence suggests that much of the limited class of wealthy U.S. citizens who may have expatriated for tax avoidance purposes involves second and third generation wealth.").

295. JCT Report 3, *supra* note 9, at 4.

296. Letter from Harvard Professors Wolfman, Avi-Yonah, and Ring to Leslie Samuels, attached as an appendix to the Statement of Leslie B. Samuels, Assistant Secretary (Tax Policy), Department of the Treasury, Before the Senate Finance Committee, July 12, 1995, *available in* LEXIS, Fedtax Library, TNT file, 95 TNT 135-21.

expatriation it is quite easy for an expatriate to avoid future U.S. transfer tax liability. The 1996 amendments to the FITA expatriate regime did not materially change the scope of the expatriate transfer tax provisions.

The lack of attention focused on the expatriate transfer tax provisions may reflect a (sound) belief that once a person and his property are no longer located in the United States, it would be impossible to meaningfully enforce any extraterritorial transfer tax. Since enhancement of the expatriate transfer tax provisions would be fruitless, one approach may be to give property that is inherited (or received as a gift) from an expatriate a zero basis or treating gifts and inheritances as income.[297] There are sound tax policy reasons for including all gifts and bequests in income,[298] but a regime applicable only to direct heirs and transferees may raise issues of horizontal equity. In addition, if the bequest or gift is large enough, a person may be induced to expatriate prior to receiving it. There may also be administrative problems. Another approach would be to treat expatriation as a deemed death: upon expatriation, a citizen would be deemed to transfer his property to himself and be subject to U.S. wealth transfer taxes at that time.[299] This approach, however, raises significant issues of tax neutrality and distributional concerns.[300]

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297. City Bar Report, *supra* note 14, at 918; *see also* Gene Steuerle, *supra* note 294 (advocating an inheritance tax on U.S. heirs of expatriates). The proposed legislation adopts the second approach. Proposed I.R.C. § 102(d), The Small Business Job Protection Act of 1996, H.R. 3448, 104th Cong. (1996). In combination with a mark-to-market regime, a provision making gifts and bequests income may be confiscatory. For example, assume that an expatriate owns stock of IBM with a fair market value of $1000 and a basis of zero. Upon expatriating, an income tax of $400 will be due. If the expatriate dies, and the stock is subject to U.S. estate tax, the estate will be reduced by an additional $330 (55% times $600). If the remaining $270 is subject to income tax of $108 (40% times 270), the total U.S. tax would be $838. In contrast, if the person had not expatriated, the total maximum U.S. tax would have been, $730, consisting of the income tax from the sale of the stock and the estate tax on the remaining amount..

298. Joseph Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 HARV. L. REV. 1177 (1978).

299. *See* Abreu, *supra* note 14, at 1150-57.

300. *Id.* at 1154-56.

B. *The Accumulated Earnings of Foreign Corporations That Become Subject to U.S. Tax Jurisdiction*

One corollary of mark-to-market taxation for persons and property becoming subject to residence or trade or business basis taxation is that built-in gains accruing prior to being subject to U.S. tax jurisdiction are eliminated for U.S. tax purposes. Should this rationale be extended to unrealized income and loss in corporate solution, for example, the accumulated earnings and profits of foreign corporations? Assume that a nonresident owns 100 percent of the stock of a foreign corporation and causes the corporation to distribute all of its appreciated property prior to the shareholder becoming a U.S. resident, and the shareholder recontributes the property to the foreign corporation. Under section 311(b), the corporation will realize gain (that is not taxed by the United States), which will increase its earnings and profits. Under section 312(b), the earnings and profits will be decreased by the fair market value of the property (gain plus basis) when the distribution is made. Under section 301(d), the basis of the property received will be its fair market value, which will carry over to the corporation under section 351, but which will not increase the corporation's earnings and profits. Thus, it is possible, with preresidency distributions, to eliminate a foreign corporation's earnings and profits at no U.S. tax cost, with the consequence that subsequent distributions of property and money will constitute a taxable dividend only to the extent of earnings and profits accumulated after the shareholder becomes a U.S. resident.

Extending a mark-to-market treatment to indirectly held property is inconsistent with the general tax rule that corporations are taxed separately from their shareholders. It is consistent, however, with one of the purposes of marking to market property brought into U.S. tax jurisdiction, namely, to prevent U.S. tax from being a trap for the unwary. There may also be some administrative concerns raised by this approach, for example, in the case of a shareholder of a widely held company becoming subject to U.S. residence basis taxation.

C. *State Tax Issues*

The underlying principle of mark-to-market taxation in the context of international tax is that accrued gain and loss should be taken into account when a person leaves U.S. tax jurisdiction, because the U.S. will lose the right to tax such gain. The same issue can arise when persons move from one state to another. For example, assume that a resident of New York who owns a personal residence in New York, sells the residence, moves to New Jersey, and buys a new residence. Since state tax law generally follows the federal law with respect to nonrecognition transactions, any accrued gain will not be taxed by New York, even though it accrued while the person was a resident of New York. States, perhaps, should give some consideration to taxing gains that accrue to a person (or property) who leaves the jurisdiction of the state.

VIII. CONCLUSION

Congress should reconsider its approach to taxing expatriates and immigrants. The current expatriate tax rules can be entirely avoided by holding foreign assets or deferring, for ten years, the sale of U.S. property. To enforce these provisions, the Service must monitor an expatriate's dealings in property for ten years following expatriation, an impossible administrative task, given that the person and the property may be located outside of the United States. For immigrants, under current law, pre-residency gain and loss can affect U.S. tax liability. Because a person contemplating becoming a resident can eliminate pre-residency gains by merely selling and repurchasing his property prior to becoming a resident, current law can be described as a trap for the unwary.

A mark-to-market approach for both expatriates and immigrants would ameliorate many of the defects of current law. Not only would it eliminate the inequities and inefficiencies of current law, but it would be consistent with other Code provisions that protect residence basis taxation. Furthermore, it would provide a policy framework to address similar issues.